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MAINSTORMING 2021

ECONOMY & INFRASTRUCTURE

(DECEMBER 2020 TO SEPTEMBER 2021)

1. GROWTH AND DEVELOPMENT

1.1 GDP Projections

Why in news?

Recently, NSO projected that GDP of the current fiscal will be around Rs 134.4-lakh crore in constant prices rebounding after pandemic-induced slump of the preceding two quarters.

What does this data indicate?

- After contracting by almost 16% in the April-September period, GDP is just short of Rs 10,400 crore when compared to the second half of the earlier figure.
- NSO has assumed that output will recover vigorously in the third and fourth quarters & it is highly optimistic about the expenditure side and gross value added of various industries.
- NSO expects manufacturing sector to shrink 9.4% this fiscal & the GVA of services components-trade, hotels, transport- to contract over 21.4% over the 12-month period.
- COVID-19 mandated social distancing norms has severely affected services sector which contributes almost a fifth to overall GVA.
- Private consumption expenditure — the single biggest component propelling GDP— is estimated to shrink 9.5% in the full year after contracting nearly 19% in the first half.
- This reflects the fact that consumers had shed their suspicion in spending in the face of COVID-19.
- They will now begin to consume goods and services close to pre-pandemic levels & this will reduce the instances of job losses.

Is this data overestimated?

- The NSO projects that government final consumption expenditure (GFCE) will jump to 17% in the second half after first-half's contraction & boost to a growth of 5.8%.
- But the end-November fiscal deficit data shows that the government is lagging well behind its budgeted revenue & capital expenditure targets.
- Hence it is hard to project how GFCE can increase so appreciably in the second half.
- So these estimates are likely to undergo revisions & upcoming Economic Survey could move away from these overly optimistic assumptions with more clear assessment of the economy.

1.2 Understanding India's GDP Fall

What is the issue?

- In the latest estimates of economic growth (for the financial year that ended in March 2021), India's Gross Domestic Product (GDP) contracted by 7.3% in 2020-21.
- It is imperative, in this context, to understand the reasons for this contraction in GDP.

How could this be approached?

- There are two ways to view this contraction in GDP:
    1. To look at this as an outlier - India, like most other countries, is facing a once-in-a-century pandemic
    2. To look at what has been happening to the Indian economy over the last decade, and more precisely over the last 7 years

- Notably, between the early 1990s until the pandemic hit the country, India grew at an average of around 7% every year.
- So, the latest GDP data suggests that India's economy had been steadily worsening during the current regime even before the Covid-19 pandemic.
- The "fundamentals of the economy" (a bunch of economy-wide variables showing an economy's health) suggest this, as discussed below.

How has the GDP been?

- The GDP growth rate has been a point of growing weakness for the last 5 of these 7 years.
- After the decline in the wake of the Global Financial Crisis, the Indian economy started its recovery in March 2013.
- This recovery turned into a deceleration of growth since the third quarter (October to December) of 2016-17.
- While RBI does not state it, the demonetisation move and the hastily implemented GST impacted the economy (already struggling with bad loans in the banking system).
- Consequently, the GDP growth rate steadily fell from over 8% in FY17 to about 4% in FY20, just before Covid-19 hit the country.
- In January 2020, the GDP growth fell to a 42-year low (in terms of nominal GDP).

What is the GDP per capita level?

- GDP per capita is the total GDP divided by the total population.
- It is used to better understand how well-placed an average person is in an economy.
- From 2016-17, India's GDP per capita started decreasing.
- As a result, India has been losing out to other countries.
- Even Bangladesh has overtaken India in per-capita-GDP terms.

How has unemployment rate traversed?

- Between 2012 and 2018, the total number of employed people fell by 9 million.
- This is the first such instance of total employment declining in independent India's history.
- India started routinely witnessing unemployment rates close to 6%-7% in the years leading up to Covid-19.
- This is against the norm of an unemployment rate of 2%-3%.
- More worrying is the fact that unemployment rate is falling even when the labour force participation ratehas been falling.
- With weak growth prospects, unemployment is likely to be the biggest challenge in the coming years.

How about inflation rate?

- In the first 3 years, the current government greatly benefited from very low crude oil prices.
- Oil prices (India basket) stayed close to the $110-a-barrel mark throughout 2011 to 2014.
- It then fell rapidly to just $85 in 2015, coming to below (or around) $50 in 2017 and 2018.
- The sudden, sharp fall in oil prices allowed the government to completely deal with the high retail inflation in the country.
- But since the last quarter of 2019, India has been facing persistently high retail inflation.
- Even the demand destruction due to lockdowns induced by Covid-19 in 2020 could not extinguish the inflationary surge.
- Going forward, inflation is a big worry for India.

What about fiscal deficit?

- Fiscal deficit too is a concern.

- In the Union Budget 2021, the government conceded that it had been underreporting the fiscal deficit by almost 2% of India's GDP.
- Even before Covid-19, it was an open secret that the fiscal deficit was far more than what the government publicly stated.

How strong is the Rupee as against the Dollar?

- A US dollar was worth Rs 59 in 2014. Seven years later, it is closer to Rs 73.
- The relative weakness of the rupee reflects the reduced purchasing power of the Indian currency.

2. PUBLIC FINANCE

2.1 Sinuous recovery of GST revenues

Why in news?

GST collection in the last month of 2020 was over Rs 1.15-lakh crore which is respite for the fiscally hit government.

Why was this overflow in revenue collections?

- GST inflows have stayed above Rs 1-lakh crore for three months in a row averaging Rs 1.05-lakh crore.
- Since the launch of GST in July 2017, this indirect tax inflow is highest.
- GST on imports grew a robustly 27% in November even though overall merchandise imports contracted by 13.33%.
- After February 2020, for the first time in the December month there was 7.6% surge in imports.
- This indicates that GST on imports will rise further in the coming months.
- Similarly car sales surged for the fifth month in a row in December.
- This will only boost the GST receipts in January but also give revenue from the compensation cess.
- The new GST rules which is effective from January 1 is expected to tighten GST compliance further & revenue inflows will persist.

What are some worrying factors in spite of revenue inflows?

- In November, Core sectors recorded yet another contraction after a minor uptick.
- As per the Centre for Monitoring Indian Economy (CMIE), new investments in the October to December 2020 quarter declined to 88% when compared to a year ago.
- It also highlights the fact that employment levels declined significantly in October.
- It is followed by almost 35 lakh job losses in November & this will continue to deteriorate in December.

What can we infer from this data?

- After two quarters of a sharp shrinkage in the economy due to COVID-19 lockdown, this data indicates that third quarter might see a headline growth.
- Finance Ministry has also said that the 12% year-on-year buoyancy in GST's revenue reflects rapid post-pandemic economic recovery.
- This buoyancy in revenue is supported by efforts like improving the compliance following a recent crackdown on indirect tax evaders.
- However it is important to find out the impact of the above efforts on the revenues.
- This information can give a clear picture on of how much revenue actually came from normal economic activity in November, which is what December revenues largely account for.
- Since November was India's festive season this number was high.
- But these numbers may moderate in the upcoming months even though growth rates may stay high due to a low base effect.

2.2 Revenues from GST

Why in news?

Recently revenues from the GST hit an all-time high, surpassing the previous month's record.

Why the revenue was high?

- In April 2020, GST collections had dipped to a mere Rs. 32,172 crore due to national wide lockdown which affected all the economic activity.
- In October 2020, GST revenues was around Rs. 1.05 lakh crore and since then there was a steady increase with hopes of a sustained recovery.
- In April 2021, revenues from the GST was Rs. 1,41,384 crore surpassing the previous month's record of about Rs. 1.24 lakh crore.
- This is essentially driven by the transactions in previous month, due to heightened economic activity.
- The rising COVID-19 cases and the fear of an impending lockdown could have driven people to make advance purchases in anticipation.
- Moreover, firms in the process of closing annual accounts may have remitted higher GST based on audit advice.
- Also gradual tightening of the compliance regime, pro-active co-ordinated probes against taxpayers using fake bills to evade liabilities has also played a significant role.

What are the future prospects?

- Now going by the restrictions imposed in several States, supply chain disruptions are not expected to be as challenging.
- However, weakening demand will trigger a recalibration of production and investment plans
- In 3rd week of April 2021, major two-wheeler producers saw reduced sales when compared to March 2021.
- Gradually, plants began to shut down in order to reduce inventory build-ups.
- In a report, Crisil has warned of several indicators sliding since mid-April, including GST e-way bills which fell by over 6% for two weeks in a row.
- As per IHS Markit, manufacturing orders' growth hit an eight-month low in April.
- The pandemic surge and desperate shortage of health infrastructure have prompted industry leaders to pitch for a stringent lockdown.
- Now it is hard to expect GST and other tax revenues to stay robust until government gets a better grip on infections and vaccinations.

What can be done now?

- With the Assembly polls over, the Centre must convene the GST Council.
- The council should look into rationalisation of GST rate slabs, rearrange the rates on critical pandemic supplies and the address the issue of bringing fuel under GST.
- It must begin release the shortfalls in GST compensation to States.

2.3 Government Disinvestment Programme

What is the issue?

- The government's ambitious disinvestment programme offers investors an opportunity to become shareholders in what were so far closely-held institutions.
- In this backdrop, here is an assessment of the various opportunities and the risks involved.

What are the plans for disinvestment?

- In Budget 2021-22, the government announced a strategic sale/ disinvestment policy for four strategic sectors.
- These include banking, insurance and financial services.

- The government will have a "bare minimum presence" in these sectors.
- The government completely exits PSUs through the strategic sale.
- Apart from this, the Centre has lined up minority stake sale through various routes including offer for sale (OFS) and initial public offering (IPO).
- The biggest will be the IPO of LIC.
- The Budget has also announced privatisation of two public sector banks (in addition to IDBI Bank) and one general insurance company in the upcoming fiscal.
- Privatisation of the two banks will set the trend for a long-term project that envisages only a handful of state-owned banks.
- The rest will be either consolidated with strong banks or privatised.
- The Centre has pegged the disinvestment target for the upcoming fiscal at Rs 1.75 lakh crore.
- This is compared to Rs 2.1 lakh crore budgeted in 2020-21.
    - OFS has been the preferred route for disinvestment.
- Increasing the FDI limit in insurance from 49% to 74% is expected to lead to an unprecedented expansion of the insurance sector.
- This could also give retail investors the chance to ride this profitable sector on a long-term basis.

How does it benefit retail investors?

- The progress on privatisation plans of BPCL, Shipping Corporation of India and CONCOR, among others, has already led to a big rally in their shares.
- Investors bet that the new management and private ownership would bring in higher efficiency leading to higher profits.
- As privatisation will be a long-drawn process over 5-10 years, patient investors can pick and choose the companies they want to bet on.

What is the scope to buy PSU stocks in the secondary market?

- Some do not want to get into the unknown territory of profits resulting out of privatization.
- For them, there is an existing pool of PSU stocks and exchange traded funds to choose from.
- Central public sector enterprises, public sector banks and the insurance companies have been favoured by institutional investors in recent months.
- There has been a steady recovery in PSU stocks, especially after the government announcement on a strategic sale policy and clear intent on privatisation.
- As the equity markets are showing steady recovery, the PSU stocks will continue to do well at least in the medium term.
- Consumption- and privatisation-focused stocks such as IRCTC, BPCL, Shipping Corporation, BEML, and PSU banks are expected to offer reasonable returns over the medium term.

What are the other opportunities?

- As market sentiments have revived after the Covid-19 pandemic, around Rs 1 lakh crore of public issues (excluding LIC) under IPOs are waiting to hit the markets in the near term.
- Markets are likely to witness a bull run in the next financial year as well.
- IPOs of public sector firms earlier were not very encouraging as the pricing was not proper.
- However, recent IPOs provided good gains for investors.
- All these hint at a favourable climate for investment.

What are the risks involved?

- The fate of the IPO market is clearly linked to the performance of the stock market.
- If bond yields in the US rise further, the equity market will get hit as foreign investors might pull out.

- For the current economic recovery to sustain, containing bond yields is essential.
- It should be done not through 'yield curve management' but through moderating inflation expectation.
- Other risk factors are the possibility of a spike in Covid and lockdown, further rise in crude oil prices, rise in inflation and a possible rise in interest rates.

2.4 State Budgets - Need for Government Spending

What is the issue?

- Several state governments have presented their budgets for the financial year 2021-22.
- States have spent less in this year, and may focus on fiscal consolidation in the year to come, weakening the hopes of a public-spending-led recovery.

What is the projection on government spending?

- There was much a collapse in states' revenues in the last fiscal given the pandemic times.
- Transfers from the Centre thus become a key aspect in the last financial year.
- This was coupled with a "reluctance" among some states to borrow more to spend.
- So at the aggregate level, spending by these states in 2020-21 will end up being lower than what they had budgeted for before the onset of the pandemic.
- The revised estimates peg their total expenditure to decline by around 6% in 2020-21 from their budget estimates.
- These are based on 11 states that account for a little over 60% of India's GDP.
- These trends may hold for the other states as well.
- In that case, the "additional" spending by the central government, over and above its budget estimate, is likely to be offset by the decline in spending by states.
- In effect, the total general government spending may end up being around or even lower than what was budgeted for before the onset of the pandemic.

How is the revenue status?

- This year, states which typically run revenue surpluses will run revenue deficits.
- The revenue collapse meant that states that usually borrow to finance capital expenditure have had to borrow for recurring expenditure as well.
- As a result, capital spending by states, which was budgeted to be around 50% more than that of the Centre in 2020-21, has been cut sharply.
- The states had to cut back even on some of its revenue expenditure.
- Notably, most of these states have cut back on allocations for pensions.
- Some have even slashed allocations for salaries this year.

What is the gap among the states?

- Some of the states did have the leeway to boost spending by borrowing more.
- The Centre had raised the ceiling on their market borrowings from 3 to 5% of GSDP.
- Of this 2 percentage point increase in the borrowing limit, part was unconditional while the remaining was subject to fulfilling Centre-mandated reforms.
- Several states did qualify to undertake the conditional borrowings.
- But, it is only the low-income states with already stretched finances that seem to have availed the additional borrowing space.
    - [These include Bihar, Rajasthan and Madhya Pradesh; their budgeted fiscal deficit for 2020-21 was pegged at 3% or above before the pandemic.]
- They were thus able to either maintain or exceed their budgeted expenditure levels.

- In comparison, the high-income states of Gujarat, Maharashtra and Karnataka, that were better placed to borrow more and spend, have not done so.
- The economic hit from the pandemic is thus uneven.
- The growth projections accompanying these budgets suggest that some states expect to do better than others.
- But, considering the extent of the crisis, there has to be far greater spending than what is visible in these budgets.

What is the scope for fiscal consolidation?

- As is the case with the Centre, states have, remarkably, budgeted for aggressive fiscal consolidation next year.
- The average fiscal deficit across these states is expected to fall by more than 1 percentage point of GSDP.
- This is more than twice the decline recommended by the 15th finance commission.
- This aggressive consolidation is expected to be achieved not by expenditure compression, as is the case with the Centre, but by significant revenue enhancement.
- However, some revenue assumptions are quite ambitious.
- E.g. some states have pegged their GST and VAT collections to grow far in excess of 30% in 2021-22

2.5 Reforming Subsidies

How consumption will get affected due to the pandemic?

- India's growth forecasts are now 1-2 percentage points lower due to the second wave of coronavirus.
- But the actual economic toll may be higher and consumption demand may remain subdued longer than currently foreseen and there are sufficient reasons to justify this fact.
- One, lethality of virus and its spread, severe human and economic scarring, fear-persistence due to the anticipated third wave, and lack of guaranteed vaccination will affect the consumption.
- This is in addition to the drained financial strength from health expenses and income losses, increased indebtedness.
- Two, the supply-side stress is also affecting the consumption pattern.
- MSMEs are affected by shutdowns which affect their sales, raw material procurements and supply chain linkages.
- Large firms are impacted by labour shortages due to migration, infections, lowered sales and future demand uncertainties.
- As a result, there is feeble demand for credit and loan restructuring in the banking sector.
- Three, it is expected that reopening the economy will be accompanied with more infections in forthcoming months which will reduce demand.

What are the steps to be taken?

- It is advocated that budgeted expenditures should be reoriented to meet the emergency health and income requirements.
- The government should act along the structural lines and prepare a fiscal space for this emergency of unknown magnitude and longevity.
- It must follow the efforts of deepening the revenue-expenditure reforms as it did last year.
- This involves reforms to agriculture marketing and institutional structures, accounting transparency by bringing subsidy arrears (food, fertilisers) on the balance sheet, raising LPG prices.

What is the issue in this?

- Recently, there has been regression with the increase in fertiliser subsidies instead of revising issue prices.
- This can derail the reform momentum and diminish the credibility of effort and commitment to improve finances.

- Therefore any reform should aim to reduce subsidies over the medium-term in a modest fashion.
- For example, it can choose between different ways to moderate the food subsidy, i.e. streamlining the beneficiary eligibility and numbers or revising the issue prices or a mix of both.
- Other welfare and often populist expenditures, at both state and central levels should also be reviewed.

What is the inference?

- This stretching pandemic of unknown duration and spread will worsen the employment-income situation of the people.
- RBI cannot alone lead with its monetary measures and fiscal policy measures needs to be taken.

2.6 Tax Policy in Trying Times - Rewriting India's Tax Laws

What is the issue?

- As a result of the pandemic-induced lockdown, India's GDP contracted consecutively for two quarters from April to September 2020.
- However, some have gained from the pandemic, and this highlights the need for a relook at India's archaic tax laws.

Who have gained during the pandemic?

- India's super rich only became richer in the first half of 2020 - in some instances by over three times.
- Between January and June 2020, 85 new Indians were added to the list of High Networth Individuals (with a net worth of more than $50 million).
    - While this happened, the economy was on the verge of plunging into recession.
- Those dealing in stock exchanges also gained.
- When the GDP is contracting, some stocks are surging to phenomenal heights.
- The third set of gainers comprises corporate houses, Internet service providers, laptop makers and scientists engaged in medical research.
- The fourth set comprises manufacturers of masks and Personal Protective Equipment.
- **Downsides** - For most of the country, the pandemic led to unemployment and an increase in poverty levels.
- The migrant crisis revealed how thousands struggled to make ends meet.

What was the government approach?

- Pure economics dictates a big fiscal stimulus at the time of falling GDP and unemployment.
- But the government chose to rely more on monetary policy like credit easing and liquidity flow.
- The fiscal stimulus was provided in stages.
    - It stood at merely 2% of the GDP compared to Japan's fiscal stimulus (21% of the GDP), Brazil's (10%) and China's (7%).

How has tax structure favoured corporate growth?

- Corporate profits have risen sharply at the expense of wages and small and medium enterprise profits.
- Corporate tax rates have been lowered to moderate levels but multilateral corporates have found an easy way to make big money in the time of COVID-19.
- Digitalisation and e-commerce have made their job simpler.
- The tax administration is struggling with the implementation of the equalisation levy.
    - Non-resident e-commerce operators were brought within the scope of this levy by the Finance Act of 2000.
    - Online sales of goods and services will be taxed at 2%.

- Clarity is required in implementation.

- **Taxing MNCs -** The taxation of multinational corporations has become a perennial problem.
- The nexus rule versus residence rule haunts tax administrations in all countries where multinational corporations operate.
- Tax avoidance by global web companies has become acute because of digitalisation.
- Digital taxation has to be amended in accordance with the UN Model Convention.
- There is need for India to act in sync with the OECD (Organisation for Economic Co-operation and Development).
- E.g. Canada plans to levy new taxes on foreign technology companies to increase government revenues.
- **Indirect taxes -** In the field of indirect taxes, the government has been vigorously following whether MNCs are passing on the benefits of tax reduction to consumers.
- As per the GST law, any reduction in the tax rate on the supply of goods or services has to be passed on to the consumer by way of commensurate reduction in prices.
- But companies are prone to benefit from GST rate reduction without passing on the benefits to the end consumers.
- To address this, the Anti-Profiteering Rules have to be implemented vigorously.

2.7 Digital Services Tax

Why in news?

United States Trade Representative (USTR) reported that India's DST is discriminatory & inconsistent with international tax principles.

How does India's DST evolve?

- In 2016, **Akhilesh Ranjan Committee** suggested to create a level-playing field between online businesses and brick-and-mortar businesses.
- Since digital businesses don't have physical presence but enjoy a sustainable economic presence they need to be taxed.
- In 2016, India became the first country to implement the equalisation levy, on advertising services at 6%.
- In 2018, India introduced the term significant economic presence in Income Tax Act.
- According to which, if a company had users in India, it sort of defined its economic connection with India and therefore gives India the right to tax.
- In 2020, the new equalisation levy expanded its scope even to e-commerce.

Digital Service Tax

Digital companies are not adequately taxed because they don't have a physical location in the markets where they operate.

DST aims to ensure that non-resident, digital service providers pay their fair share of tax on revenues generated in the Indian digital market.

How is India's DST different from the U.K.?

- India's equalization levy was on the company's revenue rather than on profits but U.K. allows companies not to pay any tax if their net operating margin is negative.
- If an Indian user located in the U.K., receiving services from a U.S. company, U.K. DST contemplates that only 50% of the revenues from such a transaction would be chargeable to U.K.
- In U.K., DST excludes companies that sell their own inventories but India's equalisation levy covers everything under the sun.
- This makes U.K. different from India on its implementation but U.S. also looks at the U.K. taxes in some way as discriminatory.

Is India's DST discriminatory?

- USTR reports find DST as discriminatory because tax incident by design is on non-resident company's levy.
- But the market itself is dominated by U.S. firms hence it finds discriminatory but reality is not so.
- Moreover the threshold that India has laid down for the equalisation levy is actually much below what the EU envisages.
- Moreover the levy aims to create a level-playing field with ordinary businesses have a physical presence & pay regular taxes.
- Now international communities are moving towards a scenario where such transactions need to be taxed.
- Hence to say that levy violates international tax principles is not valid.

2.8 U.S. Retaliatory Tariff on Digital Service Taxes

Why in news?

The United States announced and then immediately suspended retaliatory tariff imposition on digital service taxes (DST) on six countries including India.

What are the digital services taxes in India?

- The government had moved an amendment in the Finance Bill 2020-21.
- It imposed a 2% digital service tax.
- It applies to trade and services by non-resident e-commerce operators with a turnover of over Rs 2 crore.
- This includes e-commerce operators involved in supply of services, including online sale of goods and provision of services.
- [The move effectively expanded the scope of equalisation levy.
- Till the previous year, the equalisation levy only applied to digital advertising services.]

WHAT IS THE PROPOSED TARIFF?

- The retaliatory tariff on digital service taxes (DST) was proposed for a period up to 180 days.
- It was proposed to be imposed on Austria, India, Italy, Spain, Turkey, and the U.K.
- The US announced 25% tariffs on over $2 billion worth of imports from these six countries.
- It then immediately suspended the duties to allow time for international tax negotiations.
- [In India's case, around 26 categories of goods are in the preliminary list of products that would be subject to the additional tariffs.]

- Estimates indicate that the DST payable by US-based company groups to India will be up to approximately $55 million per year.
- So, the U.S. proposal, if applied, would collect duties on Indian goods in the range of the same amount of DST that India collects from US companies.

What is the U.S.'s concern?

- The digital services taxes in these countries primarily impact Silicon Valley tech giants.
- The tariff proposed on goods from them was approved following a "Section 301" investigation.
- The investigation looked into the digital services taxes imposed by the above countries.
- It found that the taxes discriminated against US digital companies.
- They were against tech companies like Apple, Amazon, Google and Facebook.
- The taxes were also inconsistent with principles of international taxation.
- [The investigation was initiated by the Trump administration in June 2020.

- The deadline for approving tariff action based on the investigation is around now.]

What is the rationale for the suspension now?

- The Biden administration seems to agree with the findings of the Trump era investigations on digital services tax (as being discriminatory).
- It is thus likely that Biden is using the tariff proposal as a tool to speed up the international negotiations.
- Negotiations on international taxation are going on at the OECD and in the G20 process.
- In this context, it is to be noted that at this point in the fragile, post-COVID-19 recovery, the world can hardly afford another tariff war.
- Notably, the digital services sector has enjoyed low-tax or tax-free operations across the world for decades.

2.9 SC Ruling on Taxation of Overseas Software

Why in news?

- The Supreme Court held that the amounts paid by Indian companies for the use of softwares developed by foreign companies do not amount to 'royalty.'
- Also, such payments do not give rise to income which is taxable in India.

What does this mean?

- The SC has followed the globally-accepted interpretation.
- Accordingly, payment made by end-users and distributors is akin to payment for sale of goods.
- It is not for grant of licence under the Indian Copyright Act.
- So, the buyer only gets the right of use, and not the intellectual property of the software.
  - Only where copyright in the software is permitted to be exploited by the payer can the payment take the character of royalty.
- Indian companies thus need not deduct tax for the amount they pay to foreign manufacturers and suppliers for use or re-sale of computer software through end-user licence agreements (EULA).
- This ruling should now prevent similar disputes, but a few questions still require deliberation.

What are the unaddressed issues / challenges?

- **Refunds** - Both Indian payers (importers) and non-resident sellers must evaluate the impact of the ruling on pending disputes.
- The underlying issue has been put to rest.
- So now, the taxpayers will be looking to obtain refunds of taxes paid against demands raised or taxes paid by way of withholding tax deposited.
- In cases where this aspect has not been disputed in the past, fresh claims for refunds will have to be lodged.
- This will be either by the non-resident payee or resident payer depending on the type of contracts.
- Thus, review of the contracts for software supplies is necessary to determine eligibility for refunds and lodge claims.
- For refund claims barred by the statute of limitations, taxpayers may need to approach the Central Board of Direct Taxes for directions for grant of refund.
- **Foreign tax credits** - Another impact is on the foreign tax credits (FTC) claimed by non-resident sellers in their home-country against the taxes paid or withheld in India.
- Such non-residents will have to ascertain the right quantum of FTC credit claimed in their home-country.
- They will then have to evaluate the risk of reversal or reduction of claim.
- **TDS** - There are many resident payers who adopted a non-taxability position at the withholding stage.
- But given the different stance of the tax laws, demands were raised/tax recovered from the purported failure to withhold tax at source.

- In such cases, the payers may have recovered back-taxes from the non-resident payees, invoking tax indemnification clauses under the contract.
- Such non-resident payees may now seek a refund from the payers.

How will the ruling benefit?

- The ruling brings much-needed certainty on characterisation of software transactions.
- This is especially true for non-resident taxpayers facing the ire of the retrospective amendments.
- The rationale laid down by the apex court will be relevant for all pending cross-border tax disputes.
- However, the non-resident taxpayers will have to ensure that they meet the eligibility for treaty entitlement such as beneficial ownership and evidence of a valid tax residency.
- Given the stakes involved, it is certain that the government treasury has to pay a few hundred crore in refunds.
- The ruling, however, provides clarity in interpreting tax laws applicable to cross-border transactions and reassuring taxpayers.

2.10 US Treasury's Call for a Global Minimum Tax

Why in news?

U.S. Treasury Secretary Janet Yellen recently urged the adoption of a minimum global corporate income tax.

What is the rationale?

- Major economies are aiming to discourage multinational companies from shifting profits and tax revenues to low-tax countries regardless of where their sales are made.
- Increasingly, income from intangible sources such as drug patents, software and royalties on intellectual property has migrated to these jurisdictions.
- This, in turn, is allowing these companies to avoid paying higher taxes in their traditional home countries.
- With a broadly agreed global minimum tax, the Biden administration hopes to reduce such tax base erosion.
- This could be done without putting American firms at a financial disadvantage, allowing them to compete on innovation, infrastructure and other attributes.

HOW WOULD A GLOBAL MINIMUM TAX WORK?

- The global minimum tax rate would apply to companies' overseas profits.
- So, if countries agree on a global minimum, governments could still set whatever local corporate tax rate they want.
- But, if companies pay lower rates in a particular country, their home governments could "top-up" their taxes to the agreed minimum rate.
- This would eliminate the advantage of shifting profits to a tax haven.
- The Biden administration in the U.S. has said that it wanted to deny exemptions for taxes paid, to countries that did not agree to a minimum rate.

- The Trump administration attempted at capturing revenues lost to tax havens with a U.S. corporate offshore minimum tax in 2017.
    - The "Global Intangible Low-Taxed Income," or GILTI, tax rate was only 10.5% - half the domestic corporate tax rate.

How about the international tax talks?

- The Paris-based Organization for Economic Cooperation and Development (OECD) has been coordinating tax negotiations among 140 countries for years on two major efforts.
    - These are setting rules for taxing cross-border digital services and curbing tax base erosion, with a global corporate minimum tax part of the latter.
- The OECD and G20 countries aim to reach consensus on both fronts by mid-2021.

- If deals on both efforts are enacted, companies will end up paying an extra corporate tax.
- The minimum tax is expected to make up the bulk of this $50 billion-$80 billion extra corporate tax.
- The OECD recently said that governments broadly agreed already on the basic design of the minimum tax.
- However, the rate remains to be agreed, which is a challenging task.
- Other items still to be negotiated include -
    i. whether industries like investment funds and real estate investment trusts should be covered
    ii. when to apply the new rate and ensuring it is compatible with the 2017 U.S. tax reforms aimed at deterring tax-base erosion

What is the challenge with finalising the minimum rate?

- The Biden administration wants to raise the U.S. corporate tax rate to 28%.
- So, it has proposed a global minimum of 21% which is double the rate on the current GILTI tax.
- It also wants the minimum to apply to U.S. companies no matter where the taxable income is earned.
- That proposal is far above the 12.5% minimum tax that had previously been discussed in OECD talks.
    - This level happens to match Ireland's corporate tax rate.
- The Irish economy has boomed in recent years from the influx of billions of dollars in investment from foreign multinationals.
- So, Ireland which has resisted European Union attempts to harmonize its tax rules for more than a decade, is unlikely to accept a higher minimum rate without a fight.
- However, the battle for Ireland and other low-tax countries is less likely to be about trying to ruin the overall talks.
- Rather, it is more about building support for a minimum rate as close as possible to its 12.5%.

2.11 Re-examining the EPF Tax Rules

Why in news?

The new EPF tax rules will come into effect from April 1, 2021 as announced in the Union Budget of 2021.

What was the existing rule?

- If a person contributes more than the limit prescribed under **Section 80C of the Income Tax Act**, he cannot get a tax break on his excess contribution.
- The earnings on contributions rarely suffered taxation since tax laws pegged tax-free earnings to higher rates than the interest rate on the EPF.
- Moreover the person will pay tax on their corpus, only if he withdrew it within 5 years from the comment of the contribution.
- This taxation framework incentivised employees to use the EPF as their primary retirement saving and it acted as risk-free retirement savings mode.

What is the new rule?

- The new tax regulation will label a person as a high net worth individual if he misuses EPF by contributing more than Rs 2.5 lakh per annum to the EPF.
- The limit is Rs 5 lakh in cases where employers do not make contributions to the provident fund.

What is the issue with new rules?

- With the new rule coming into effect, government assumes what is adequate for an individual on retirement.
- The decision on a common threshold of adequacy is incorrect and suffers from the flaw of one-size-fits-all approach.
- Moreover the word **'misuse'** that was used to justify the imposition of the tax is difficult to comprehend.

- This is because EPF is solely a payroll deduction and cannot be contributed in any other manner.
- The new clause of taxing the amount exceeding the limit prescribed in the act brings the EPF to the borders of double taxation.
- 65% of EPF is invested in government securities and rest is invested in largely in PSU bonds and earnings available to the employee through interest credit mechanism.
- Despite the stickiness of these interest rate declarations and their often being higher than market rates, it is certain that the government does not subsidise this interest rate credit.

Why it is difficult to administer?

- In addition to these flaws, there are difficulties in administrating the new tax rule.
- Due to the changed of threshold fromRs 2.5 lakh to Rs 5 lakh, there can be various interpretations surrounding the applicability to EPF.
- It is also unclear if the interest on such excess contributions is taxed once during the year of contribution or throughout the term of investment in EPF.
- The mechanism of tax communication from the EPFO to the member also remains uncertain.

What are the takeaways from this?

- The EPF remains a subsidy-free, pay-what-is-earned retirement fund and typifies safety with governance.
- Though pension funds are seen by governments in multiple policy contexts, they should remain, foremost, the retirement funds of the beneficiaries.
- Regulations governing contributions, taxation, investments, administration and benefits should be made in the interest of the beneficiary.
- But it seems that other imperatives dominate the agenda in pension policymaking in India.
- Therefore, the resultant outcomes are sub-optimal from a beneficiary point of view.
- Therefore the policy makers need to relook the new rules and the immediate rollback of it demonstrates the will of the policymakers to encourage retirement savings.

2.12 G7 Global Corporate Tax Deal

Why in news?

The Group of Seven (G7) countries have backed the proposal to impose a common global corporate tax.

What are the decisions taken?

- The tax proposal endorsed by the G7 countries (US, UK, Germany, France, Canada, Italy and Japan) has two parts.
- The agreement made will be discussed in detail at the upcoming meeting of G20 financial ministers and central bank governors.
- **First part** - Countries around the world should tax their home companies' overseas profits at a rate of at least 15%.
- This 15% of global minimum corporate tax would deter the practice of using accounting schemes to shift profits to a few very low-tax countries.
- [Often, these tax havens are the Caribbean Islands such as Bahamas or British Virgin Islands.
- Or at times, it is countries like Ireland where the corporate tax rate is as low as 12.5%.]
- **Second part** - This allows countries to tax a share of the profits earned by companies "that have no physical presence but have substantial sales."
- For instance, this could be through selling digital advertising.

What is the rationale?

- The G-7 statement echoes an earlier US proposal.

- The US had urged the world's 20 advanced nations to move in the direction of adopting a minimum global corporate income tax.
- It urged countries to tax part of the earnings of the largest and most profitable companiesif they are doing business within their borders.
- It also supported awarding countries the right to tax 20% or more of profit exceeding a 10% profit margin.
- The decision to ratify the 15% floor rate by G7 follows from the same route, to deal with low-tax jurisdictions around the globe.
- It addresses the low effective rates of tax shelled out by some of the world's biggest corporations.
- These include digital giants such as Apple, Alphabet and Facebook, as well as major corporations such as Nike and Starbucks.

Who will benefit?

- The proposal works well for the US government at this time.
- The same holds true for most other countries in western Europe.
- This is true even as some low-tax European jurisdictions and some in the Caribbean rely largely on tax rate arbitrage to attract MNCs.
- The second part of the G7 proposal is expected to impact companies that rely on the digital medium to drive their profits.
- However, after the imposition of a common global corporate tax, countries are advised to revoke their respective digital services taxes.
- So, this would benefit the large tech companies, especially the Silicon Valley companies.
- [The US considers those unilateral digital services taxes to be unfair trade measures that single out the American tech companies such as Google, Amazon and Facebook.]

What are the challenges though?

- A global minimum rate would take away a tool that countries use to push policies that suit them.
- For instance, in the backdrop of the pandemic, developing countries with less ability to offer mega stimulus packages may experience a longer economic hangover than developed nations.
- A lower tax rate is a tool they can use to alternatively push economic activity.
- So, there are challenges in getting all countries to agree for the proposal as it impinges on the right of the sovereign to decide a nation's tax policy.

What does it mean for other countries?

- **China** is not likely to have a serious objection with the proposal.
- But an area of concern for it would be the impact of such a tax stipulation on Hong Kong.
- Hong Kong is notably the seventh-largest tax haven in the world and the largest in Asia.
- Also, China's strained relationship with the US could be a deterrent in negotiations on a global tax deal.
- **India** - In a bid to revive investment activity, the FinMin, in 2019, announced a sharp cut in corporate taxes for domestic companies to 22%.
- And for new domestic manufacturing companies, it was brought to 15%.
- Given this, India is likely to look into the pros and cons of the new proposal as and when it comes, and the government will take a view thereafter.

2.13 EU's Carbon Border Tax - India's Concerns

Why in news?

Indian Environment Minister expressed concerns at the European Union's (EU) plan to levy an additional 'carbon border tax' to discourage import of carbon-intensive goods.

What is the rationale?

- Two key reasons for the carbon tax proposal are EU's environmental goals and its industries' global competitiveness.
- Recently, the EU declared it would cut its carbon emissions by at least 55% by 2030 compared to 1990 levels.
- EU's greenhouse gas emissions have fallen by 24% compared to 1990 levels.
- But emissions associated with imports are increasing.
- These contribute 20% of the EU's carbon dioxide emissions.
- So, a carbon tax would incentivise other countries to reduce GHG emissions.
- This can further shrink the EU's carbon footprint.
- Secondly, the 27 EU member states have much stricter laws to control GHG emissions.
- It has an 'Emissions Trading System' that caps how much GHG individual industrial units can emit.
- This makes operating within the EU expensive for certain businesses.
- So, the EU authorities fear that these firms might prefer to relocate to countries that have more relaxed or no emission limits.
- This is known as 'carbon leakage' and it increases the total emissions in the world.

What is EU's proposal?

- Earlier, the EU Parliament had adopted a resolution to implement a 'Carbon Border Adjusted Mechanism' (CBAM).
- To begin with, by 2023, the CBAM would cover energy-intensive sectors which includes cement, steel, aluminium, oil refinery, paper, glass, chemicals as well as the power sector.
- A recent draft regulation pertaining to the CBAM proposed that goods entering the EU would be taxed at the borders.
- Such a tax would promote "low-carbon, resource-efficient manufacturing."
- The UK and the US are also considering such proposals.

Who all have opposed it?

- The BASIC (Brazil, South Africa, India, and China) countries' grouping had opposed the EU's proposal, terming it "discriminatory."
- It is said to be against the principles of equity and 'common but differentiated responsibilities and respective capabilities' (CBDR-RC).
- These principles acknowledge that richer countries have a responsibility of providing financial and technological assistance to developing and vulnerable countries to fight climate change.
- Developing nations feel that the developed nations have failed to fulfil the Green Climate Fund commitments.
- Under this, developing nations were to receive $100 billion for green development by 2020. This has now been delayed to 2025.

How does this impact India?

- A carbon tax would increase the prices of Indian-made goods in the EU.
- That would make Indian goods less attractive for buyers and shrink the demand.
- This would create serious near-term challenges for companies with a large greenhouse gas footprint.
- It would get to be a new source of disruption to a global trading system.
- Notably, EU is India's third largest trading partner.
- It accounted for $74.5 billion worth of trade in goods in 2020, or 11.1% of India's total global trade.
- India's exports to the EU were worth $41.36 billion in 2020-21.

2.14 OECD Tax Proposals - Implications for India

Why in news?

India and the majority of the members of OECD-G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) have joined a new two-pillar plan to reform international taxation rules.

What is it about?

- The OECD recently issued a statement indicating consensus amongst 130 nations (out of 139 participants) on the two-pillar plan.
- The announcement marks the culmination of international negotiations since the BEPS (Base erosion and profit shifting) 2015 reports.
- [It has overcome the shock due to the previous US administration withdrawing from the Inclusive Framework discussions.]
- The key objective is to ensure that large Multinational Enterprises (MNEs) pay tax where they operate and earn profits.

How will India be benefitted?

- The consensus adds much-needed certainty and stability to the international tax system.
- For India, the outcome is crucial because of its active engagement in the OECD-led deliberations.
- India had strongly advocated greater taxing rights to source or market jurisdictions.
- This has indeed been the demand of most developing countries.
- Because new-age MNEs have figured out the basis to limit their global tax incidence.

TWO PILLAR SOLUTION

PILLAR ONE

- It ensure a fairer distribution of profits and taxing rights among countries, with respect to the large Multinational Enterprises (MNEs), including digital companies.
- It would re-allocate some taxing rights over MNEs from their home countries to the markets where they have business activities and earn profits.
- This will be regardless of whether the firms have a physical presence there or not.

PILLAR TWO

- It seeks to put a floor on competition over corporate income tax.
- It does this through the introduction of a global minimum corporate tax rate.
- The countries can use this minimum tax to protect their tax bases.
- Pillar Two which was initially proposed to be brought into effect from 2023 has now been deferred to 2024.

- They work through innovative tax structures and invisible presence due to digital technologies, within the framework of the current treaty principles.
- The Indian law-makers will now have to make a refined and nuanced direct taxation law.

What are the concerns for India?

- **Application -** The proposals include complex rules.
- Itincludes applying formulas to data relating to global business revenue of the MNE group.
- Also, its application requires real-time information sharing and conjoint implementation by the tax-authorities across the globe.
- Despite the policy level alignment of the participating countries, achieving such shared tax-assessment in practice is challenging and uncertain.
- **Limited scope -** By design, the two pillars cover a small class of taxpayers.
- - MNEs which have a global turnover above 20 billion euros and net profitability above 10% for Pillar One.
- Given that the coverage is limited, the disputes and differences in approach are likely to continue for taxing smaller players.
- **Net benefit -** Accepting the two-pillar solution brings taxing rights for the participating nations.

- Simultaneously, it implies foregoing the taxing rights for others.
- In other words, it is a trade-off, of taxing the big to spare the poor.
- This sounds wise on a progressive-taxation scale and horizontal equity ideal.
- But it may not be fair since it is not necessary that the biggest MNEs earn from India more.
- It also discounts the possibility of taxing the smaller MNEs who earn big from India.
- So, who will have the net benefits from applying these rules remains a question.
- Specifically for India, accepting the two-pillar solution implies it being under pressure.
- It has to undo its new international tax measures, particularly the equalisation levy, and possibly modify its nexus-based Significant Economic Presence.

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD)

- It is an international organization that works to build better policies for better lives.
- It brings together Member countries to collaborate on key global issues at national, regional and local levels.

BASE EROSION AND PROFIT SHIFTING (BEPS)

- It refers to tax planning strategies that exploit gaps that exist between tax rules of different jurisdictions and minimizes the overall corporate tax.
- It is done by either making tax profits 'disappear' or shift profits to low tax jurisdictions where there is little or no genuine activity.
- BEPS strategies are not illegal. They just take advantage of different tax rules operating in different jurisdictions.

2.15 Doing Away with Retrospective Tax

Why in news?

- The Union Finance Minister recently introduced the Taxation Laws (Amendment) Bill in the Lok Sabha.
- A key provision was doing away with the contentious retrospective tax law of 2012.

What is India's retrospective tax law of 2012?

- The retrospective tax provision was introduced in 2012 as an amendment to the Income Tax Act, 1961.
- It allowed the government to tax companies on mergers and acquisitions (M&As) that happened before 2012.
- In effect, it aimed to bring past indirect transfer of Indian assets under the ambit of taxation.
- The law was thus used to raise large tax demands on foreign investors like Vodafone and Cairn Energy.
- It was hence blamed for impairing India's investment climate.

What is a Retrospective Tax?

- A retrospective tax taxes a transaction that took place prior to the law being framed.
- It can be a new or additional charge on transactions done in the past.
- Countries use this form of taxation to rectify any deviations in the taxation policies.
- Retrospective tax affects companies that had unknowingly or knowingly used the tax rules differently.

What are the two major cases in this regard?

- UK-based telecom giant Vodafone bought a 67% stake in Hong Kong-based Hutchison Whampoa for $11 billion.
- To this transaction, the Indian government raised a demand of Rs 7,990 crore in capital gain.
- It said the company should have deducted the tax at source before making a payment to Hutchison.
- The company took the matter to the Supreme Court.
- The Court ruled in favour of Vodafone saying that it could not be taxed retrospectively.
- To overcome the legal hurdle, the retrospective taxation law was introduced.
- With this, the I-T department slapped Rs 3,100 crore tax notice on Vodafone India.
- Another such move was also made against the 2006 internal corporate restructuring carried out by UK-based Cairn Energy.
- Both Cairn and Vodafone filed lawsuits in international courts against India's retrospective tax.
- Separate international arbitration tribunal verdicts in the Vodafone and Cairn cases have ruled against India's retrospective tax demands.
- The tax amendment now has been prompted by Cairn Energy's relentless pursuit to enforce the arbitration award.

What are the current changes?

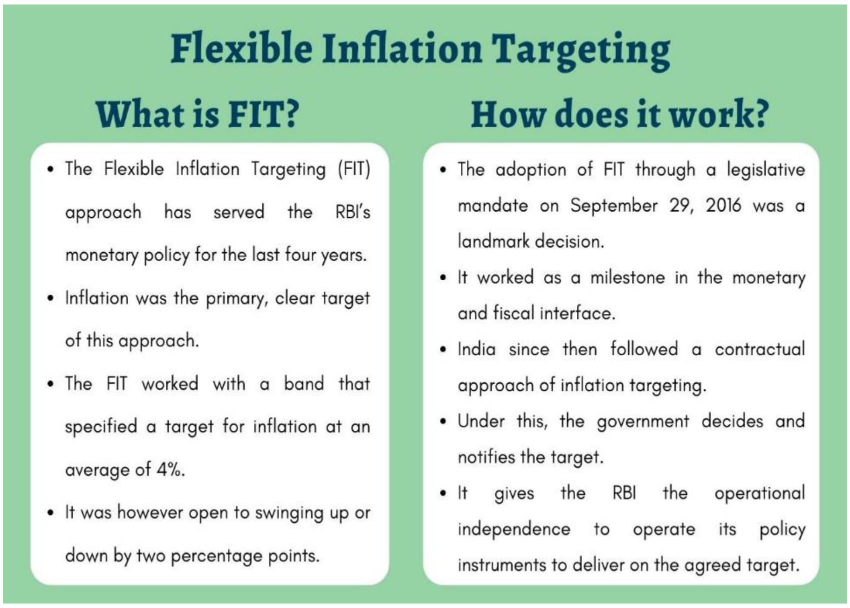
- The Taxation Laws (Amendment) Bill nullifies the relevant retrospective tax clauses introduced in 2012.
- As per the proposed changes, any tax demand made on transactions that took place before May 2012 shall be dropped.
- And any taxes already collected shall be repaid, albeit without interest.
- To be eligible, the concerned taxpayers would have to drop all pending cases against the government.
- They should also promise not to make any demands for damages or costs.
- Going ahead, India needs to demonstrate greater clarity and consistency in policy across the board (trade tariffs, GST, etc.,) to fix its broken credibility.

3. INFLATION

3.1 Flexible Inflation Targeting

What is the issue?

- The 4% and +/- 2% target cycle for inflation under the Flexible Inflation Targeting (FIT) approach comes to an end this fiscal (March 31, 2021).
- With the government tasked to notify the revised numbers, here is a look at how the target so far has worked.



How has FIT performed?

- Since the inception of FIT in 2016, GDP growth starting 2016-17 and ending 2019-20 stood at 8.26, 7.04, 6.12 and 4.18 (all in Y-o-Y and in percentage terms).
- In the same period, the average

inflation rate was at 4.5, 3.6, 3.4 and 4.8 (in percentage terms).

- So in the first four years, the mandate has been met.
- To that extent, it can be said that the monetary policy has been effective.

What is the recent inflation scenario?

- The COVID-19 pandemic has put severe pressure on the monetary policy objective.
- There was an unprecedented contraction in the growth rate of 23.9% in Q1 and 7.5% in Q2 of 2020-21, and an estimated contraction of 7.7% for fiscal 2020-21.
- Worryingly, the headline inflation rate remained above the upper band of 6% for eight consecutive months during the period April–Nov 2020.
- However, the December 2020 CPI inflation is at 4.59% on Y-o-Y basis.
- This was mainly on account of deceleration in food inflation by 3.87%.
- The Monetary Policy Committee (MPC) in its December 2020 resolution had stated that the inflation rate will come down to 5.8% in Q4 of 2020-21, with risks broadly balanced.
- Thus, the RBI is hopeful of returning to the target as soon as the supply side bottlenecks ease.

Why should FIT continue?

- FIT has worked reasonably well with the average of 4% and a band of +/- 2%.
- A reasonable band of 2% on the lower side and 6% on the upper side gives the RBI manoeuvrability for inflation management.
    - This is especially given the fact that India has many uncontrollable variables, most notably monsoons.
    - Besides food inflation, fuel inflation is also dependent upon the volatility of crude oil prices.
- Also, 4% headline inflation with an upper ceiling of 6% keeps the core inflation (headline inflation minus food and fuel inflation) at an appropriate level.
    - This is because there is a co-movement of core inflation with the headline inflation and vice versa.
- Any increase in the band above 6% will put pressure on the RBI in anchoring inflation expectations.
- On the lower side of the band, any inflation rate lower than 2% has the potential risk of the economy entering in a deflationary situation.
- Prior to the adoption of FIT, the RBI did not have the exposure in terms of responding to the CPI inflation.
- Earlier, WPI was taken as inflation measurement. However, CPI gives a weightage of around 46% to food inflation on which the RBI has no control.
- Over the four-year period since FIT adoption, the RBI's CPI inflation forecasting has been reasonably successful.
- RBI has also been effective in anchoring inflation expectation in a three-month and one-year ahead time frame.

3.2 Success of Inflation Targeting

Why in news?

The government can continue with the current Monetary Policy regime after it successfully completed its five year term.

What is the history behind the Inflation targeting?

- In May 2016, the Reserve Bank of India (RBI) Act, 1934 was amended to provide a Constitutional basis for the implementation of the flexible inflation targeting (FIT) framework.
- The act allows the Centre to set the inflation target in consultation with the RBI once every five years.
- On that basis, India's inflation target was set at 4 % with a 2 % extension in the upper bound and 2 % in the lower bound.

Was this policy implementation successful?

- The average inflation rate measured through the GDP deflator which was 5.69 % five years in the pre-inflation targeting period has declined to 3.47 % in the last five years.
- India is one of the highest achievers of reducing inflation when compared to other Asian Nations..
- Consumer Price Index (CPI) inflation declined from 8.26 % during the 2011-2015 to 4.99 % in 2016-2019, a 3.27 % point fall.
- This is highest among both inflation-targeting countries as well as those that did not adopt it.
- India has also achieved a substantial fall in average inflation volatility during the said period.
- It was 7.93 % for five years before inflation targeting now declined to 0.89 % during the inflation targeting regime.
- This fall is highest compared to Indonesia, Thailand, Philippines and Korea.

How is this possible?

- This is possible because of the Central government's strong coordination with monetary policy committee despite fiscal dominance in developing countries like India.
- This maintenance of a stable inflation rate provides certainty to inflation and investment decisions for sustainable growth.
- However, some critics of inflation targeting feel that its sole focus on price stability ignores growth imperatives.
- But the RBI Act rightly opted for maintaining price stability as its prime objective while giving due importance to economic growth.
- The real GDP growth did not decline during this period which was 6.50 % during 2011-2015 increased marginally to 6.63 % during 2016-2019.

How has transparency got improved?

- The Inflation Expectations Survey of Households (IESH) shows that the inflation expectation has been forward-looking in the post inflation targeting period in India.
- The lagged impact of past inflation expectations on current inflation expectations was significantly higher before the adoption of inflation targeting.
- This lagged dependency has fallen in the FIT framework regime which suggests that households are increasingly using the current and future information to form inflation expectations.
- This implies that transparency in monetary policy is helping to reduce inflation expectations.

How is this transparency is possible?

- RBI is following the international practices to increase communication with financial markets and the citizens.
- The frequency of the Monetary Policy Committee meeting is set at 6 times per year which is in line with most of the developed countries.
- RBI takes two weeks to release minutes of the proceedings of MPC, which provides a forecast of CPI inflation and GDP growth.
- Further, every 6 months, the RBI publishes a Monetary Policy Report where it explains the sources of inflation and provides an inflation forecast for 6-18 months ahead.

What can we infer from this?

- The inflation targeting in India has been a success story and India must continue with the FIT regime.
- The RBI has toiled to achieve its credibility and has rightly earned the goodwill and confidence of the financial markets around the world.
- The review committee should try to find out areas of further improvement in the monetary policy framework which will strengthen the MPC to achieve the inflation target.
- It should also disclose the models used in inflation and GDP forecasting as other inflation-targeting countries do.

- Further, the RBI may include a forecast of core inflation in the minutes.

3.3 On Retail Inflation

What is the issue?

- India's retail inflation - Consumer Price Index (CPI) - slowed to a 16-month low of 4.06% in January 2021.
- However, various factors make the inflation outlook for the coming months less encouraging.

What is the inflation scenario?

- Inflation appears to have cooled after having stayed stubbornly stuck above the RBI's upper tolerance threshold of 6% for six months through November 2020.
- The latest retail inflation readings offer monetary authorities a fair amount of comfort.

What was the driving factor?

- The deceleration was helped by an appreciable softening in food prices.
- Specifically, the Consumer Food Price Index reflected a gain of a mere 1.89% in January 2021.
  1. vegetable prices saw a disinflation of 15.8%
  2. cereal prices eased considerably for a second month in the wake of kharif crop arrivals
- The RBI in its recent monetary policy statement, cited the below as factors that augured well for the months ahead-
  1. the bumper kharif crop
  2. rising prospects of a good rabi harvest
  3. larger winter arrivals of key vegetables
  4. softer egg and poultry demand on avian flu fears

What is the need for caution though?

- **Food costs** - The central bank was mindful of the risks too. This is especially with regard to food costs.
- The latest data on this had brought to the fore concerns over the prices of pulses and edible oils.
  - While inflation in pulses and products was at 13.4%, that for oils and fats stood at 19.7%.
  - Eggs, and meat and fish, both posted double-digit rates of 12.9% and 12.5%, respectively.
- **Base effect** - Inflation moderated by more than 100 basis points in February 2020 to 6.58% before slowing to 5.84% in March 2020.
- This favourable base effect is also beginning to wane.
- So, the outlook for the coming months is far from reassuring.
- **Input cost** - Of particular worry is the trend in input costs for multiple sectors in the real economy, including manufacturing.
- From automobile manufacturers to builders, rising raw material costs are beginning to force them to pass on the impact to the end consumers.
- And this is going on when demand is yet to pick speed.
- The latest Purchasing Managers' Index (PMI) points to the sharpest increase in purchasing costs for more than 2 years.
  - This is because of the continuing supply-side squeeze.
  - The resulting inflationary pressures made manufacturers to raise their product prices at the fastest pace in over a year.
- **Fuel price** – Adding to the above concerns is the rising transportation fuel prices to newer and newer record highs in recent days.
- Diesel, the main fuel for freight carriage, has now exceeded Rs.80 per litre.

- This is bound to feed into prices of almost everything being transported across distances.
- With this, the outlook for inflation becomes distinctly darker.
- Policymakers need to maintain a strict vigil to keep inflation from resurging and posing a threat to macro-economic stability.

3.4 Retail Inflation & Industrial Output Data

What is the issue?

- The National Statistical Office (NSO) released the retail inflation and industrial output data.
- It offers some relief from the economic impact of second wave of the COVID-19 pandemic, but there are still factors to remain cautious about.

What is the inflation scenario?

- Provisional headline inflation (Consumer Price Index (CPI)) slowed to a three-month low of 4.29% in April, 2021.
- This was a result of softer food prices and a statistical base effect.
- A closer look at the inflation data reveals a substantial cooling in the prices of cereals, milk and milk products, vegetables, and pulses and products.
- Both cereals and vegetables saw a deflationary trend widen to -2.96% and -14.2%, respectively.
- Dairy products, which have the second-largest weight in the food and beverages category, also slid into deflation territory at -0.13%.
- Price gains in pulsesdecelerated into single digits to reach a 20-month low of 7.51%.
- [Earlier price gains in pulses had been bothering monetary policy makers by having been stuck in the double digits over an 18-month stretch.]
- The combined impact of these slowed inflation across the food and beverages group by more than 250 basis points to 2.66%.

What is the need for caution?

- The same Consumer Price Index data also point to persistent price pressures.
- Price gains in meat and fish increased to 16.7% and was little changed at 10.6% in the case of eggs.
- Inflation in oils and fats accelerated almost 100 basis points to 25.9%.
- Transport and communication also remained in the double-digit range at 11.04%.
- This was despite benefiting from the virtual freeze in the pump prices of petroleum products that coincided with recent Assembly elections.
- Global crude oil is starting to rise again and local petrol and diesel prices are resuming their upward trajectory.
- So, the prospect of haulage costs — for transporting goods from factory and farm gates — rising in the near term is very real.
- All these could potentially result in faster inflation in the coming months, also amidst the impact of the lockdown in several states.
- This, along with rising international commodity prices, the outlook for inflation gets even more uncertain.

What is the industrial output scenario?

- A separate NSO release showed March 2021 industrial output jumped by 22.4%.
- This again benefitted from the fact that the Index of Industrial Production (IIP) had posted an 18.7% contraction in March 2020 during lockdown.
- But, industrial production numbers may also provide cheer only for a limited period.
- New orders and output have slowed to eight-month lows in April 2021.

- The pandemic-triggered factory shutdowns further threaten supply disruptions, industrial production, and thus, inflation faces challenges.

What is the way forward?

- Measures to bolster demand are the need of the hour amidst the lockdown-induced economic impact.
- Nevertheless, policymakers must stay vigilant to ensure price stability.

3.5 Draft Report - Working Group on WPI Revision

What is the issue?

- The draft technical report of the working group on revision of current series of WPI 2011-12 to new series 2017-18 is out, seeking comments.
- Revisions of the base year for Wholesale Price Index (WPI) are welcome, but creation of a producer price index should also be expedited.

What are the highlights of the draft report?

- Changing the base year for the WPI from 2011-12 to 2017-18 is required.
- This is key to reflect the structural changes in the economy, including demonetisation and GST.
- The working group has made a comprehensive evaluation of the changing consumption patterns of wholesale products and has expanded the basket.
- The number of items in the manufactured products index has increased from 564 in the current index to 1,026.
- The number of primary articles index has increased from 117 to 131 and fuel and power index from 16 to 19.
- The weight of primary articles in the new series is higher.
- This is mainly due to higher food prices in the period considered.
- Share of fuel prices has moved lower to 11.24% from 13.15%.
- This is due to the lower crude oil prices in that period.
- Manufactured products continue to have the largest share at 63.93% in the new index.
- Using the average consumption of 3 years from 2015-16 to 2017-18 is a good way to smoothen the short-term volatility in prices.
- [But average of 5 years instead of 3 years could have been considered.]
- **Business Services Price Index** (BSPI) - The report recommends having a BSPI.
- Merging BSPI with the WPI will help capture the inflation in services more accurately.
- The report suggests six price indicesas separate indices and a combined BSPI.
- The separate indices are BSPI-Banking, BSPI-Insurance, BSPI-Securities, BSPI-Telecom, BSPI-Air Transport and BSPI-Railways.
- This index can be used by National Accounts Division, MOSPI, as a deflator in national accounts.

How suitable is WPI?

- The WPI was the primary

CPI AND WPI

- Both CPI and WPI measures the inflationary trends i.e. movement of price signals within the broader economy.
- WPI tracks year-on-year wholesale inflation at the producer or factory gate level / purchase of bulk inputs by traders.
- CPI, on the other hand, tracks changes in price levels at the shop end, thus reflective of the inflation experienced at the level of consumers.
- The two indices differ in the manner in which weightages are assigned.
- This applies to food, fuel and manufactured items as well as their sub-segments.
- E.g. weightage of food in CPI is far higher (46%) than in WPI (24%).
- WPI does not capture changes in the prices of services but CPI does.

inflation gauge prior to 2014.

- But since then, the consumer price index (CPI) has become the key data point used to formulate monetary policy.
- So, the focus on WPI has reduced over the years.
- The WPI is now mainly used as a deflator for nominal macroeconomic aggregates such as GDP and IIP.
- It is also used to determine escalation clause in infrastructure projects, revision of toll rates, tariff setting in ports, electricity and so on.
- The WPI has a mix of primary commodities and manufactured products as its constituents.
- This renders it unsuitable as a measure of producer price inflation.

What is the need now?

- There is a need for disseminating a Producer Price index (PPI), work on which is in progress.
- The PPI selects constituents based on supply use and avoids double counting.
- It will thus be a better measure of the inflationary pressure on businesses.
- The sub-group to facilitate smooth transition from WPI to PPI needs to expedite the process.
- A clutter of items that also find a presence in the CPI should be avoided.

3.6 Bi-Monthly Monetary Policy - August 2021

Why in news?

In its latest meeting, the Monetary Policy Committee (MPC) of the RBI has revised the interest rates and updated growth and inflation forecasts.

What are the highlights?

- The key policy rate (Repo rate- the RBI's lending rate to banks) is kept unchanged at 4% for the seventh time in a row.
- Reverse repo rate [RBI's borrowing rate from banks] is kept at 3.35%.
- The MPC has raised the inflation target for fiscal 2021-22 to 5.7% from 5.1% projected earlier.
- But it has maintained the growth forecast at 9.5%.

What is the rationale?

- The nascent and hesitant economic recovery post-pandemic needs to be nurtured through fiscal, monetary and sectoral policy levers.
- Elevated inflation level and delayed recovery in the economy would have prompted the panel to keep rates steady.
- This accommodative stance will thus continue as long as necessary to revive and sustain growth and to mitigate the impact of Covid-19.
- The MPC however sees to it that inflation remains within the target.

What about the inflation scenario?

- The new inflation target of 5.7% for fiscal 2021-22 is below the RBI's upper band of inflation target of 6%.
- But adverse effects on cost conditions for manufacturing and services exist, driven by -
    1. elevated prices of industrial raw materials
    2. high pump prices of petrol and diesel
    3. logistics costs
- However, the weak demand conditions are affecting the pass-through of the cost burden to output prices and core inflation.
- Crude oil prices are volatile with implications for imported cost pressures on inflation.

- A calibrated reduction of the indirect tax component of fuel prices by the Centre and states can help to substantially lessen cost pressures.
- Given all these factors, inflation may remain close to the upper tolerance band up to Q2 of 2021-22.
- Nevertheless, these pressures should reduce in Q3 of 2021-22 on account of kharif harvest arrivals and as supply side measures take effect.

How is the growth forecast?

- The MPC has retained the real GDP growth at 9.5% in 2021-22.
- The investment demand is still weak.
- But, improving capacity utilisation, rising steel consumption, higher imports of capital goods are expected to revive growth.
- The supportive monetary and financial conditions, and the economic packages offered by the government will help keep the momentum.
- Innovation and working models adopted during the pandemic by businesses will continue to reap productivity gains even after the pandemic recedes.
- This should help trigger a virtuous cycle of investment, employment and growth.
- The recovery remains uneven across sectors and needs to be supported by all policy makers.

What is RBI's VRRR auction plan?

- The RBI has decided to conduct fortnightly variable reverse repo rate (VRRR) auctions.
- It plans to conduct four VRRR auctions in the fortnight beginning August 13 till September 24, 2021.
- This is to absorb surplus liquidity from the banking system.
- These enhanced VRRR auctions should not be misread as a reversal of the accommodative policy stance.
- Because, the system-level liquidity will still be more than ₹ 4 lakh crore at the end of September 2021.
- So, the amount absorbed under the VRRR window forms part of system liquidity.
- After this, the RBI will continue with its overnight fixed-rate reverse repo auction.
- The RBI will also conduct two more Government Security Acquisition Programme (G-SAP) operations of ₹ 25,000 crore each on August 12 and 26, 2021.
- The overall priority now is to nurture the existing growth impulses to ensure a durable recovery along a sustainable growth path.

3.7 Increasing Price Pressure

Why in news?

The latest retail inflation data suggests that the inflation for August has slowed for a second straight month to a 5.3% pace after July's 5.59%.

What is the current price trend?

- Edible oils have been on a rise for months and the August print was 33% after July's 32.5%.
- Inflation in two vital protein sources, eggs and pulses, also continued to remain a cause for concern.
- The pace of inflation in fuel and light, clothing and footwear, health as well as household goods and services all rose up last month.
- Transport and communication which includes pump prices of automotive fuels of petrol and diesel, stayed stuck in double digits at 10.2%.
- A wider deflation in vegetable prices was the main positive contributor in easing the overall food and beverages inflation last month.

What does this imply?

- Price trends among the constituents of CPI and WPI -based inflation show that it would be premature to drop the guard on price gains
- Recent CII poll of CEOs showed a majority 67% expect average retail inflation this year to near or exceed the RBI's upper threshold of 6%
- So, cutting the fuel taxes is a sure-shot way to address a major component of price pressure.

4. MONEY

4.1 Digital Currency

Why in news?

European Central Bank (ECB) expressed its intention to evaluate Central Bank issued Digital Currency (CBDC) for the Euro Zone.

What is the status of adopting Crypto currency around globe?

- ECB said that Bank is ready to launch a digital currency in 2-4 years in consultation with public.
- In China, Digital Currency Electronic Payment is being piloted in many cities.
- In India 3 years back, RBI reported that it is exploring the feasibility of adopting crypto currency.

What are the benefits of using official digital currency?

- It helps in curbing tax evasion as digital currency facilitates cashless transactions.
- It will not witness the volatility as CBDCs will be pegged to fiat currency.
- Official digital currencies will be of legal tender with sovereign backing it protects the consumers using it.
- It will help in distracting investors from the current bunch of crypto assets which are highly risky.
- Moreover neglecting the use of crypto currency will lead to use of it for criminal purpose by anonymous non-State actors.

Why is RBI apprehensive about the use of crypto currency?

- Since digital currencies are not backed by any asset, RBI is against the use of privately issued digital currency.
- The basic design of crypto currencies — creation & maintenance by public, with no government supervision and ease of cross-border payments — makes them vulnerable to malpractice.
- In past, crypto currencies led by Bitcoin involved in numerous scams like money laundering, terror financing and drug trafficking.
- This has lead to many crypto trading platforms shutting down.
- It would be wise to set up a committee to look into its impact on macro economy and liquidity, banking systems and money markets.

4.2 Bilateral Currency Swap Agreements

Why in news?

China is using Yuan-denominated (RNB) currency swap agreements to enhance its influence international order apart from other methods.

What is Bilateral Currency Swap agreement?

- It is an agreement between two countries to exchange their currencies at the prevailing market exchange rate.
- The borrowing country has to buy back its currency on a pre specified date at the same exchange rate in future by paying the interest.

What is the current status of China's bilateral swaps?

- Usually china uses methods likes overseas investments, lending through Chinese dominated international institutions to increase its economic influence.
- Currently it adopts currency swaps as one of its strategy.
- From January 2009 to January 2020, China has entered into such agreements with 41 countries & mostly during 2009 -2016.
- Usually they are of 3 year term but are repeatedly renewed which was highest during 2016(33) & in 2019 it was 27.
- Despite slight decline at the end of 2016 & end of 2019, the total authorised value of such aggrements is relatively stable.
- It amounted to RMB 3,333 billion between 2015 and 2019.

How it benefits partner countries?

- Borrowing countries can get access to RMB liquidity at relatively lower interest rate by using its own currency as collateral.
- It helps the partnering countries to use its available reserves to settle transactions with other countries.
- They can lend it to institutions that face foreign currency shortages.
- They can temporarily finance any current account deficit with China.
- They can shore up their dollar reserves to meet their commitments to third parties as Argentina did.

How it benefits China?

- It is tool through which other counties can rely on Chinese goods thereby enhancing its economic influence.
- It can further the goal of internationalising RMB and establishing it as an alternative reserve currency.
- Such developments made RMB as a freely usable currency in the Special Drawing Right (SDR) basket.
- It can also influence strategically-placed foreign exchange-starved neighbours like Sri Lanka and Pakistan through its support.

What are the shortcomings for China in Currency swaps?

- If borrowing central bank is unable to meet its commitments lender bank is left with collateral of the borrowing country.
- This leads to loss of value of RMB in comparison to the exchange rate at which the swap was executed.

What is the global status in Currency swap agreements?

- Due to dominance of dollar denominated transactions in trading, US Federal Reserve was the principal source of liquidity in bilateral swap arrangements.
- However, it was very selective about the central banks in signing agreements -relatively riskless.
- During the 2008 financial crisis, it chose to extend swaps with developed country central banks & only 3 developing country central banks in Brazil and Mexico.
- Often these arrangements are made when the country concerned is undergoing balance of payments stress.
- But Chinese Central bank hasn't adopted this principle.
- Its sole aim is to increase its economic presence and strengthen the role of its currency.
- This helps developing countries which are left out of the group covered by the Fed's dollar-liquidity swap system.

4.3 Decoding Cuba's Currency Reforms

Why in news?

Cuba unified the Cuban peso (CUP) and the Cuban convertible peso (CUC) as one currency, and put an end to the decades-old dual currency system effective January 1, 2021.

How does Cuba's monetary system work?

- For nearly three decades, two currencies have circulated in Cuba - the peso (CUP) and the convertible peso (CUC).
- Both were officially valued at one-to-one with the dollar.
- Neither currency is tradable outside the country.
- The currencies are exchanged at various rates:
  i. one-to-one for state-owned businesses
  ii. 24 pesos for 1 CUC for the public and others for joint ventures, wages in the island's special development zone and transactions between farmers and hotels
- Cuba created the system as part of a package of measures to open up its economy after the collapse of the Soviet Union.
- While the system helped Cuba get through the shock of the Soviet collapse, it also ended up hiding the real economic situation.

What is the change made now?

- Cuba went with devaluation of the Cuban peso (CUP) and the withdrawal of the convertible peso (CUC). The CUC will be eliminated.
  - The CUP is in circulation in the domestic economy and serves as the principal medium by which goods are priced and wages paid.
- President Miguel Diaz-Canel said the devaluation would leave the peso at a single fixed rate of 24 to the dollar.
- The government has also begun opening stores that sell consumer goods for dollars and other traded currencies, though only with a bank card.
- This is a temporary measure but the partial dollarization will also provide some stability, especially for families who receive remittances.
- Meanwhile, state and private companies can now keep tradable currency accounts with up to 80% of their export earnings instead of handing them over to the state.

How did dual domestic currency come about?

- During the turmoil in Cuba's sugar industry and a plunge in nickel prices in the 1990s, a volatile CUP had fallen to 140 to the dollar.
- Against this backdrop, the CUC was introduced in 1994 as a unit of account and store of value.
- The objective was to prevent the country's excessive reliance on the U.S. dollar following the end of the former Soviet Union.

What is the rationale for the reforms now?

- The reforms aim to eliminate price distortions arising from multiple exchange rates and reduce Cuba's dependence on imports of basic commodities.
- These conditions have been exacerbated by -
  i. the fallout from the COVID-19 pandemic
  ii. decline in the export of the nation's famed medical services
  iii. the depletion of foreign exchange revenues from tourism
  iv. the crippling impact of U.S. economic sanctions
- In recent years, the second currency [CUC] has more or less steadied at one CUC to 24 CUPs in official exchange outlets.
- It is the predominant mode of transaction for tourists and residents at high-end shopping outlets and other imported goods.
- There are disparities attributed to the prevalence of a dual domestic currency.
- The recent shift is part of the government's bid to boost dollar transactions alongside other hard currencies.

- It came especially after tourism was closed in the wake of the pandemic.

What is the significance?

- Cuba's switch back to a single currency was an important objective in the economic transformation plan envisioned in the 2011 Congress of the Communist Party of Cuba under former President Raul Castro.
- Among the expected gains from a unified peso are -
    - transparency of firms in terms of costs and profits
    - higher economic productivity and incentives for exports
- Experts have opined that a corresponding devaluation of the peso was a necessary first step to discontinue the dual currency.
    - The government has sought to balance the likely impact of high inflation resulting from the devaluation with a generous wage and pension hike for state employees.
    - A roll-back of subsidies to state-owned firms is also proposed.

4.4 Wrong Listing

Why in news?

Recently, US Department of Treasury included India in the currency manipulator's list in its April 2021 report.

Why U.S. included India?

- The current account deficit of the US is expanding to 3.5 per cent of GDP in the fourth quarter of 2020.
- This is the largest as a share of GDP since the last quarter of 2008 so it tries try to apply pressure on its trading partners.
- The report examined the macroeconomic and foreign exchange policies of major trading partners of the US.
- It has identified five countries — Vietnam, Switzerland, Taiwan, India and Singapore — as currency manipulators.

Should India worry about the listing?

- The US Treasury identifies currency manipulators based on three factors:
    1. one-sided intervention in the foreign exchange market with the purchases amounting to at least 2 % of the country's GDP;
    2. current account surplus of at least 2%of GDP over a 12-month period;
    3. material trade surplus with the US of at least $20 billion over a 12-month period;
- One, though India's current account registered a surplus of 1.3 %of GDP in 2020, it was mainly due to falling demand leading to contraction in imports and falling crude oil prices.
- Two, India has always had a trade surplus with the US and therefore the surplus in goods trade with the US in 2020 at $24 billion is not new.
- Three, though RBI had to persistently purchase dollars through 2020 but it was not intended to help exporters.
- The purchases were mainly because of the large stimulus announced by global central banks which resulted in abundant foreign portfolio and FDI flows into the country.
- The RBI was forced to buy the dollars flooding the country, though it was inflationary and the return on dollar denominated securities was very poor.
- Therefore, RBI need not pay much attention to the US Treasury report.

What can we infer from this?

- It is quite likely that India will be out of this list because RBI has halted its dollar purchases in the spot market since February and shifted its interventions to the rupee forward market.
- With RBI to support the Centre's large borrowing programme in FY22 through purchases of Indian government bonds, the room to purchase dollar denominated securities is limited.

- Therefore, Indian currency is likely to drift with a downward bias over the coming months as the foreign capital flows are likely to be lower.

4.5 RBI's Clarification on Cryptocurrencies

Why in news?

- Some leading banks cautioned people against dealing in cryptocurrencies.
- Following this, the RBI intervened and made a clarification.

What did the RBI say and what was the trigger?

- State Bank of India and HDFC Bank cautioned their customers against dealing in virtual currencies such as Bitcoin.
- They cited the April 2018 order of the RBI on virtual currencies (VCs).
- Banks also warned customers that failure to adhere to the advisory may lead to cancellation or suspension of their cards.
- The 2018 order banned entities regulated by RBI from dealing in VCs or providing services for facilitating others to deal with or settling VCs.
- The RBI had no option but to allow it after the Supreme Court lifted the ban in 2020.
- So, the RBI now intervened and said the 2018 order was no longer valid from the date of the Supreme Court judgement (click here to know more).
- Therefore, it cannot be cited or quoted from.

What clarification does it offer?

- The RBI clarification is expected to give some relief to customers who have invested in cryptocurrencies.
- Many Indians have invested in cryptocurrencies like Bitcoin and Ethereum.
- Their money, estimated to be around Rs 10,000 crore, will not be blocked now.
- Banks, as well as other entities addressed above, may continue to carry out customer due diligence processes with existing mechanisms.
- E.g. KYC, Anti-Money Laundering (AML), Combating of Financing of Terrorism (CFT), PMLA, FEMA, etc.
- Meanwhile, the RBI is in the process of developing its own virtual currency.

5. BANKING

5.1 Fallacious Digital lending applications

Why in news?

Unauthorised digital lending apps have increased after Covid-19 induced digital transactions.

How digital lending apps work?

- According to the RBI regulations, entities which undertake lending activity have to get registered with bank or NBFC or State government as a money lender.
- But many digital lending apps have ignored these rules.
- They either disguise their loans as purchase transactions or enter agreements with registered NBFCs or banks to function as 'selling agents'.

What are the issues arising out of this?

- These apps access the borrowers call records, contact books, photo archives while disbursing their 'easy' loans.
- Later they call up borrower's contacts for naming and shaming them & they even harass women contacts.

- Reports also highlight that borrower from these apps driven to suicide, as they get into debt trap with processing charges as high as 20 % & interest rates up to 50%.
- These apps also get involved in extreme recovery practices.
- These practises violate RBI's regulations & its fair practices code, which requires a paper trail & a grievance redress mechanism for every loan disbursed.
- Unauthorised digital lending also creates regulatory arbitrage against licensed banks and NBFCs which comply with the rulebook on ownership, net worth and lending practices.

What actions are taken till now to address this issue?

- Borrowers from these lending apps can file their grievances to the RBI through email or its awareness platform — Sachet.
- In June 2020, RBI said that every digital lender must disclose the name of the bank/NBFC originating the loan.
- But these guidelines are breached to a greater extent.

What more can be done?

- The RBI needs to do more rather than just warning the public about not falling prey to such illegal entities.
- It should actively shut them down & can involve the law and order machinery, if it requires.
- The regulator should help borrowers task of verifying the credentials of banks or NBFCs that back lending apps.
- RBI website reveals 12 different categories of NBFCs, with over 9,200 firms are listed under 'Investment and Credit' entities alone.
- Borrowers will find it difficult to identify illegal entities in this large list.
- Hence a separate registration for digital lending apps has to be created similar to the one available for P2P platforms.
- The Centre & the RBI must also exert pressure on Google and Apple to actively monitor user reviews on lending apps and to take them down if they're found to be violating the law.

5.2 Need for a Bad Bank

Why in news?

As the problem of non-performing assets (NPAs) persists stressed by the pandemic, the RBI Governor has agreed to look at a proposal for creating a bad bank.

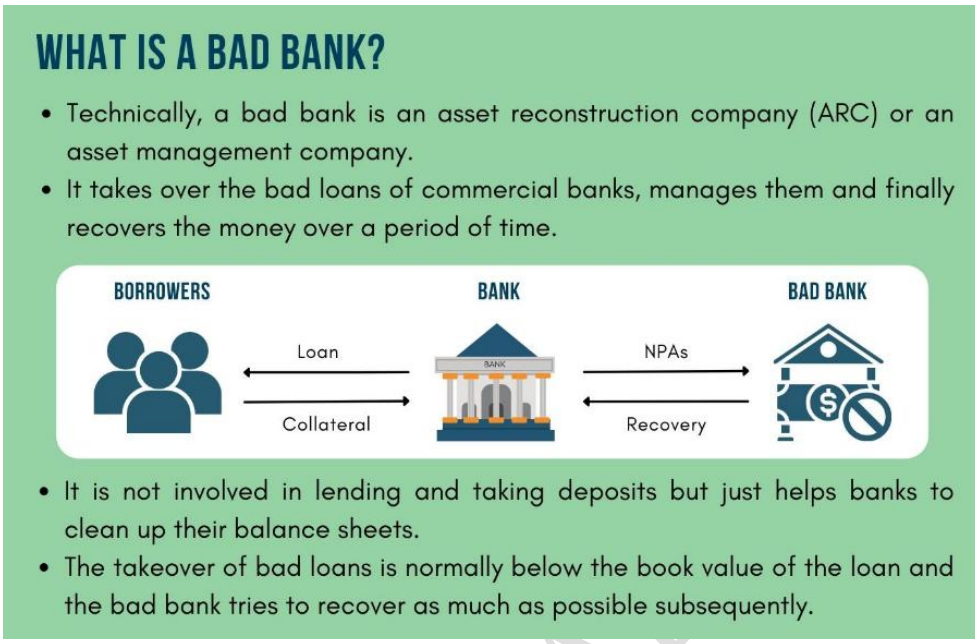
What is a bad bank and how does it work?

- A bad bank conveys the impression that it will function as a bank but has bad assets to start with.
    - Currently, loans in which the borrower fails to pay principal and/or interest charges within 90 days are classified as NPAs and provisioning is made accordingly.
- US-based Mellon Bank created the first bad bank in 1988.
- After this, the concept has been implemented in other countries including Sweden, Finland, France and Germany.
- However, resolution agencies or ARCs set up as banks, which originate or guarantee lending, have ended up turning into reckless lenders in some countries.

How serious is the NPA issue in the wake of the pandemic?

- Bad loans are expected to multiply in the wake of contraction in the economy and the problems being faced by many sectors.

- The RBI noted in its recent Financial Stability Report that the gross NPAs of the banking sector are expected to shoot up to 13.5% of advances by September 2021, from 7.5% in September 2020.
- If the macroeconomic environment worsens into a severe stress scenario, the ratio may escalate to 14.8%.
- Among bank groups, the NPA ratio of PSU banks, which was 9.7% in September 2020, may increase to 16.2% by September 2021 under the baseline scenario.



- Corporate sector debt worth Rs 15.52 lakh crore has come under stress after Covid-19 hit India.
- Another Rs 22.20 lakh crore was already under stress before the pandemic.
- This effectively means Rs 37.72 crore (72% of the banking sector debt to industry) remains under stress.
- This is almost 37% of the total non-food bank credit.

What is the need for a bad bank?

- The RBI has taken a series of measures for better recognition and provisioning against NPAs.
- There have also been massive doses of capitalisation of public sector banks by the government.
- Despite these, the problem of NPAs continues in the banking sector, especially among the weaker banks.
- The idea of a bad bank gained currency during Former RBI Governor Raghuram Rajan's tenure.
  - The RBI had then initiated an asset quality review (AQR) of banks.
  - It found that several banks had suppressed or hidden bad loans to show a healthy balance sheet.
- However, the idea remained on paper amid lack of consensus on the efficacy of such an institution.
- ARCs have not made any impact in resolving bad loans due to many procedural issues.
- Now, with the pandemic hitting the banking sector, the RBI fears a spike in bad loans in the wake of a six-month moratorium announced to tackle the economic slowdown.

How will it help?

- A professionally-run bad bank, funded by the private lenders and supported the government, can be an effective mechanism to deal with NPAs.
- The bad bank concept is in some ways similar to an ARC but is funded by the government initially, with banks and other investors co-investing in due course.
- The presence of the government is seen as a means to speed up the clean-up process.
- Many other countries had set up institutional mechanisms such as the Troubled Asset Relief Programme (TARP) in the US to deal with the problem of stress in the financial system.

What are the concerns?

- Former RBI Governor Raghuram Rajan had opposed the idea of setting up a bad bank in which banks hold a majority stake.

- Bad bank idea is like shifting loans from one government pocket (the public sector banks) to another (the bad bank).
- Indeed, if the bad bank were in the public sector, the reluctance to act would merely be shifted to the bad bank.

What are the suggestions in this regard?

- Viral Acharya, when he was the RBI Deputy Governor, had suggested the following.
- It would be better to limit the objective of the asset management companies to the orderly resolution of stressed assets, followed by a graceful exit.
- Acharya suggested two models to solve the problem of stressed assets.
- The first is a private asset management company (PAMC).
- PAMC is said to be suitable for stressed sectors where the assets are likely to have an economic value in the short run, with moderate levels of debt forgiveness.
- The second model is the National Asset Management Company (NAMC).
- An NAMC would be necessary for sectors where the problem is not just one of excess capacity but possibly also of economically unviable assets in the short to medium terms.

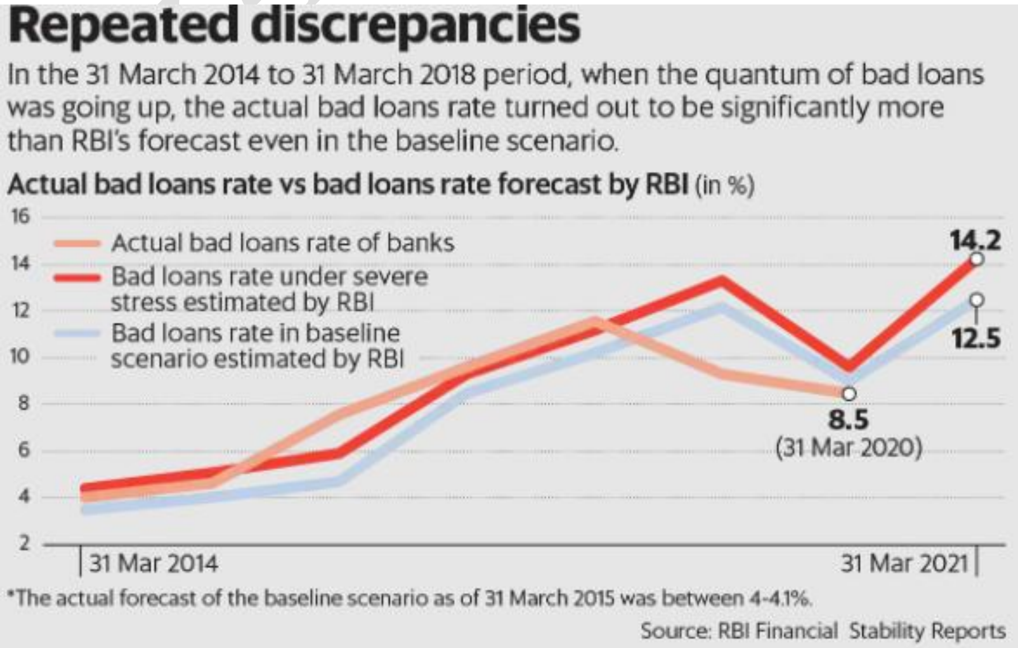
5.3 What's good about a 'bad bank?'

Why in news?

The government has set up the new bad bank structure (NARCL-IDRCL) to acquire stressed assets from banks and then sell them in the market

What are bad banks?

- Technically, a bad bank is an asset reconstruction company (ARC) or an asset management company that takes over the bad loans of commercial banks, manages them and finally recovers the money over a period of time.
- The bad bank is not involved in lending and taking deposits.
- It just helps commercial banks clean up their balance sheets and resolve bad loans.
- The takeover of bad loans is normally below the book value of the loan and the bad bank tries to recover as much as possible subsequently.
- US-based Mellon Bank created the first bad bank in 1988.



What is the recent new bad bank structure about?

- India's first-ever bad bank, **National Asset Reconstruction Company Limited (NARCL)** will acquire stressed assets worth about Rs 2 lakh crore from various commercial banks
- It will pay 15% of the agreed price in cash and the remaining 85% will be in the form of Security Receipts.
- The rest will be paid when the assets are sold by IDRCL
- The other entity, **India Debt Resolution Company Ltd (IDRCL),** will then try to sell the stressed assets in the market
- To make it work, the government has granted the use of Rs 30,600 crore to be used as a guarantee.
- If the bad bank is unable to sell the bad loan, or has to sell it at a loss, then this government guarantee of RS.30,600 crore will be invoked.

What is the need for bad banks?

- According to RBI's Financial Stability Report, the gross non-performing assets (GNPA) ratio of banks may rise to **9.8 per cent** by March 2022 from the **7.48 per cent** in March 2021
- Within the bank groups, public sector banks' (PSBs') GNPA ratio is **9.54 per cent** in March 2021
- To improve the financial health of PSBs, the government was forced to recapitalise them using taxpayers' money
- So bad banks are needed to relieve the commercial banks of their stressed assets.
- It also improves the bank's position and help them resume their normal banking operations, especially lending.

5.4 Regulating NBFC's

Why in news?

Recently, RBI has released the draft NBFC norms to tighten the control over the sector.

What are the features in the draft norms?

- It suggests classifying NBFCs into 3 layers based on size and activity- base layer, middle layer and upper layer so that they can be subjected to different degrees of regulation.
- The minimum capital requirement for NBFC licences are increased from 2 crore to 20 crore & all NBFCs with less than Rs 1,000 crore assets, P2P lenders will come under base layer.
- They won't be subjected to cash reserve ratio and statutory liquidity ratio & will follow 90-day NPA recognition norm and raised disclosure standards.
- Appointment of a Chief Compliance Officer (CCO) for following the rules is recommended.

What can we infer from these draft norms?

- The RBI has reserved its most stringent rules for the upper layer NBFC's who will be subjected to capital, provisioning and exposure rules identical to or even more stringent than banks.
- The middle layer which made up of large NBFCs, deposit-taking firms, housing finance firms will see tighter loan exposure norms, 3-year auditor rotation and Basel Pillar-III disclosures.
- It acknowledges that weak governance was the root cause for DHFL and IL&FS crises and proposed new rules for board composition, compensation and auditor appointment.
- However this may not pose much hardship to established players.

What are the positive aspects in the draft?

- There are around 9000 entities ranging from MFIs to infrastructure finance companies and scale-based regulation can give greater oversight and regulation.
- Draft norms acknowledge that too much regulation can stifle the growth of smaller firms which might hamper last-mile credit delivery.

- Hence proposed norm kept 9,209 of the 9,425 non-deposit taking NBFCs to fall in the base layer thereby majority of the existing NBFCs may get away with lighter regulations.
- NBFC's which were not following the rules especially under governance have to work hard to comply with the new framework.
- Appointment of CCO ensures FI's comply with the norms in true spirit and ensures that authority has the right to demand and get information from the management as and when required.

What are the negative aspects of the draft?

- It still continues to focus wholly on the systemic risk aspect of NBFC failures ignoring the risks to consumers from proliferating non-banks.
- Nowadays digital lending apps are tying up with small NBFCs to indulge in a range of dubious lending practices.
- Hence if small NBFCs are inadequately supervised they can cause serious damage to the system.
- More regulatory requirements can make companies to circumvent them.
- Hence it is challenging to ensure that all the rules are complied especially if the CCO is an internally appointed person as even in professionally-managed FIs these rules are avoided.
- It has been noticed that in all cases of failure in the financial sector, the issue was not the absence of regulation but the compliance part.

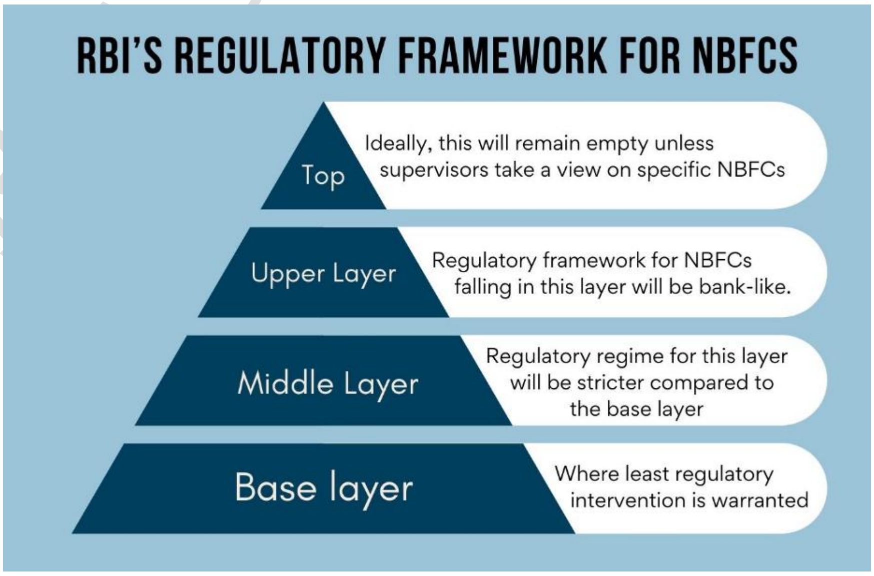
5.5 RBI's Regulatory Framework for NBFCs

Why in news?

The RBI has proposed a tighter regulatory framework for non-banking financial companies (NBFCs), in its discussion paper on revised regulatory framework for NBFCs.

What are the key provisions?

- **Classification** - The RBI has said the regulatory and supervisory framework of NBFCs should be based on a four-layered structure.
- Each of these will invite a new regulatory superstructure.
- **Regulation** - Once an NBFC is identified as NBFC-UL, it will be subject to enhanced regulatory requirement.
- This will apply at least for four years from its last appearance in the category, even where it does not meet the parametric criteria in the subsequent year.
- In other words, if an identified NBFC-UL does not meet the criteria for classification for 4 consecutive years, it will move out of the enhanced regulatory framework.



How does the classification work?

- **Base Layer** - If the framework is visualised as a pyramid, the bottom of the pyramid will be the base layer.
- It can consist of NBFCs, currently classified as non-systemically important NBFCs (NBFC-ND), NBFCP2P lending platforms, NBFCAA, NOFHC and Type I NBFCs.
- **Middle Layer** - Going up, the next layer can consist of NBFCs currently classified as –
    - systemically important NBFCs (NBFC-ND-SI), deposit taking NBFCs (NBFC-D), housing finance companies, IFCs, IDFs, SPDs and core investment companies

- Adverse regulatory arbitrage vis-à-vis banks can be addressed for NBFCs falling in this layer in order to reduce systemic risk spill-overs, where required.
- **Upper Layer** -Going further, the next layer can consist of NBFCs which are identified as systemically significant.
- This layer will be populated by NBFCs which have large potential of systemic spill-over of risks and have the ability to impact financial stability.
- There is no parallel for this layer at present, as this will be a new layer for regulation.
- The regulatory framework for NBFCs falling in this layer will be bank-like, but with suitable and appropriate modifications.
- **Top Layer** - If certain NBFCs in the upper layer are seen to pose extreme risks as per supervisory judgement, they can be put to higher and customized regulatory/supervisory requirements.
- These NBFCs will occupy the top of the upper layer as a distinct set.
- Ideally, this top layer of the pyramid will remain empty unless supervisors take a view on specific NBFCs.

What is the rationale?

- The NBFC sector has seen tremendous growth in recent years.
- The size of NBFC balance sheets is now more than a quarter of that of banks' balance sheets, from just about 12% in 2010.
- In absolute terms, their balance sheets have more than doubled, from Rs 20.72 lakh crore in 2015 to Rs 49.22 lakh crore in 2020.
- This growth is a reflection of how lighter regulations have given them the flexibility to meet a range of financing needs.
  - It offered for needs ranging from home loans to micro-finance and large infrastructure projects.
- However, this also manifested into a systemic risk.
- The risk was apparent when one of the largest infrastructure investment-focused NBFC players, IL&FS, unravelled in 2018.
  - Its payment defaults catalysed a crisis for the entire sector.
  - The collateral damage meant NBFCs could not raise funds easily.
  - NBFCs faced liquidity pressures that escalated to solvency concerns in some instances.
- In view of the recent stress in the sector, it has become imperative to re-examine the suitability of the regulatory approach.
- The regulatory framework for NBFCs thus needs to be reoriented to keep pace with changing realities in the financial sector.
- If implemented, the present changes could be the biggest overhaul of the regulatory framework for NBFCs in over two decade.

5.6 Indian Banks Association and RTI

Why in news?

Recently, Indian Banks Association said that government cannot exercise control over its functioning.

What are the functions of IBA?

- Its major objectives are rendering assistance and providing common services to the banking industry; developing and implementing new ideas and innovations in banking services etc.
- It covers broad range of services in the banking industry and

Indian Banks Association

- It is a representative body of management of banking in India and an association of Indian banks and financial institutions.
- Currently, it has members from public and private sector, foreign and urban co-operative banks, asset reconstruction companies, credit rating companies, credit guarantee funds etc.

banks follow its advice in addition to RBI's regulatory guidance.

- It also makes various recommendations to the government and the RBI over various banking-related matters like treatment of non-performing assets, formation of Bad Bank, etc.
- It conducts wage negotiation with workers' and officers' unions, and signs a wage pact called Bipartite Settlements and Joint Notes which IBA claims as authorised by banks.

What is the issue with IBA now?

- IBA claims it to be a voluntary association of member banks which is neither a governmental entity nor a regulatory authority.
- It says that it is not compliant to the writ jurisdictions of courts and not subjected to Right to Information Act, 2005.
- It has not designated any Central Public Information Officer (CPIO) till now.
- But IBA is financed by member banks and public does not know the financial status of IBA though all PSBs and listed private banks contribute to its functioning.

What does Central Information Commission (CIC) say about this?

- In RK **Jain versus Indian Banks' Association case**, CIC said that IBA qualifies to be a public authority under the RTI Act, 2005.
- This is because it performs functions as state agency and majority of its control vests in Government of India-appointed Managing Directors of public sector banks.
- Therefore it directed IBA to designate an official of the IBA as the CPIO and to comply with Section 4 of the RTI Act, 2005.
- But IBA filed a writ petition before the Delhi High Court & the Court stayed the CIC order.
- The court observed that IBA is an association of banks which has 241 members and only nine members are from public sector banks.
- It also said that case is yet to be decided whether IBA comes under RTI or not.

5.7 SC Verdict on Loan Moratorium Case

Why in news?

The Supreme Court (SC), on the loan moratorium case, declined to extend the 6 months loan moratorium, observing further that the waiver of complete interest is not possible.

What is the case on?

- The verdict came on a batch of petitions seeking –
    i. waiver of all interest during the period of the pandemic-specific moratorium
    ii. relief from compound interest for the period for all borrowers without distinction
    iii. extension of the moratorium period itself
- The petitions had also challenged the decision of the Centre and RBI to restrict waiver of interest on interest to certain categories of borrowers who had availed loans of less than Rs 2 crore.

What was the Centre's stance?

- The Centre had earlier submitted before the top court in this regard.
- Accordingly, if interests are waived on all the loans and advances to all categories of borrowers for the 6-month moratorium period, then the amount foregone would be more than Rs 6 trillion.
- If the banks were to bear this burden, then it would necessarily wipe out a substantial part of their net worth.
- This would render most of the lenders unviable and raise a very serious question mark over their very survival.

What is the Court's ruling?

- The apex court said that the waiver of complete interest is not possible as it affects depositors.

- The Court has sought to limit the scope of its juridical intervention to the questions of -
    i. whether any laws have been violated
    ii. whether any actions that banks may have taken under the policy guidance of the government and central bank likely violated any rights of the petitioners
- It observed that wisdom and advisability of economic policy were ordinarily not amenable to judicial review.
- The Bench thus denied all but one of the petitioners' pleas.
- It held that the government's decision to limit the waiver of compound interest to loans under Rs.2 crore was "arbitrary and discriminatory."
- It thus directed a refund of all compound interest levied during the moratorium period.
- The Court justly flagged the absurdity of levying the compound interest on any category of loans.
- This is because, by its very nature, it was a penal interest intended to impose a cost on wilful or deliberate default.
- However, a borrower's decision to defer repayment of instalment by availing of the moratorium could not be considered wilful default.
- Any amount collected as compound interest shall thus be adjusted to the next instalment payable instead of refunding it to the borrower, irrespective of the loan amount.
- This part of the ruling would surely come as a welcome relief to borrowers across categories and loan size.
- On the other hand, it would add a relatively smaller burden, estimated at about Rs.7,500 crore, on lenders (or the Centre, if the government decides to foot the bill and spare banks the cost).
- The verdict thus necessitates the policymakers to urgently come up with measures to help mitigate the crisis before lenders meet with more defaults.

5.8 Easing the Pain

Why in news?

Recently, RBI has announced series of measures to address the challenges posed by the ongoing second wave of COVID-19 pandemic.

What are the measures announced?

- RBI has timely intervened to alleviate any financing constraint for those impacted including the health-care sector, state governments and public.
- It provides a special liquidity window of ₹ 50,000 crore where banks can borrow up to three-year money at the repo rate to on-lend special Covid loans to priority sector classified scheme.
- Priority sector now includes entities of vaccine manufacturers, hospitals, pathology labs, suppliers of oxygen and ventilators, importers of COVID-related drugs and logistics firms.
- Small borrowers in the informal sector, micro enterprises and self-employed persons are worst hit by the localised lockdowns.
- So RBI has enhanced the provision of credit by allowing small finance banks to classify loans to small microfinance institutions.
- It has announced one-time restructuring concession which is limited to loans up to ₹ 25 crore.

What are the concerns?

- Though the scheme covers patients requiring treatment but RBI has failed to spell out how those most in need of financial assistance to cover their medical bills could borrow the funds.
- It is to be patiently seen that how much lending capital-stressed banks would be willing to write into their COVID loan books.
- The credit routed via banks cannot be substitute for direct income or livelihood support measures to households devastated by Covid.

- In the one-time restructuring scheme, Rs.25-crore threshold may be too low to make a material difference to small/medium enterprises.
- Also borrowers who received relief last year or are already in default have been specifically excluded.
- Perhaps, RBI is of the view that restructuring demands from larger borrowers can be evaluated by banks on a case-to-case basis.

What can we infer?

- RBI is mindful of its responsibilities as a regulator by avoiding instruments such as blanket loan moratoriums, interest waivers and loan classification standstills.
- Such measures dispense relief to borrower segments that don't need them and increase risks for bank depositors and investors.
- Credit support, as opposed to direct grants can create a multiplier effect as it can give relief to genuine entities.

5.9 Re-imagining PSU bank privatisation

What is the issue?

- The sudden surge in the pandemic has caused a loss of momentum in the government's privatisation exercise, but it is still a priority.
- In this context,the government will need to be careful to avoid further pitfalls, and here is a proposed strategy blueprint for that.

What are the elements to be factored in?

- **Independent authority** - Transfer the entire government stake in the relevant PSB to a separate quasi authority like SUUTI (Specified undertaking of the Unit Trust of India).
- This will signal a clear intent to divest at market prices once the bank's financial health improves.
- This would also remove the vigilance overhang that affects decision-making.
- **Governance** - In addition to reputed independent directors, strengthening the bank board is essential.
- This should bethrough addition of eminent banking talent from the industry.
- Also, making the senior bank executives accountable for time bound implementation of revised business plans is needed.
- **Capitalisation by anchor investor**- Fresh capital infusion by an anchor investor, selected amongst eligible bidders via open auction can be done.
- This is to give it a significant minority stake, thereby diluting overall government stake.
- The selection bid mechanism could be similar to erstwhile SEBI screen-based auctions that involved FPIs/FIIs placing premium bids for winning government and corporate debt limits.
- **Share sale** - There will be no stake sale to the private anchor investor.
- Over the next few years, with regular capital infusions, the anchor investor willcreep up to the desired regulatory comfort level.
- **Divestment target and dividends** - The capital receipts to the exchequer will accrue vide subsequent sales in driblets in the open market, post restoration of the banking house.
- The government, however, continues to earn revenue receipts to meet budgetary priorities.
- This will be through regular and even one-time structured dividends via SUUTI, which is expected to retain majority holding in the near future.
- A planned dividend history also benefits the share price, thereby eventually yielding better price as SUUTI pares down its holding.
- Short-run divestment shortfalls can be met by quickly disposing of marginal SUUTI/government stake in blue chips.
- Generating value from unlisted holdings like NSDL and SHCIL is another step.

- Fast-tracking smaller PSU privatisation that are far less complex than PSB divestments which attract scrutiny at every step can be taken up.
- **Stakeholder welfare**- The anchor investor brings in much needed capital for growth besides supporting the bank improve its market positioning, taking along all stakeholders.

5.10 Micro Loans in India

What is the issue?

Non-banking financial groups have gained attention for providing easy and hassle-free micro loans online, with the aid of technology.

What is micro-financing?

- Microfinance refers to the provision of basic financial services for low-income but economically active people.
- The idea is to offer loans that are easy to procure and require minimum documentation.
- Micro loans or micro financing is seen as an important tool in uplifting the weaker sections of the society.

How did micro-financing evolve?

- The concept of micro-finance came into existence way back in the 1970s.
- In the 1970s, Muhammad Yunus, professor of economics, began to hand out small loans in his home country Bangladesh.
- He founded the Grameen Bank in 1983 which today is active in over 70,000 villages in Bangladesh.
- Taking inspiration from the micro-financing reforms in Bangladesh, NABARD was developed in India.
- [NABARD - National Bank for Agriculture and Rural Development]
- Additionally, micro-financing was also developed for rural and women development through SEWA (Self-Employed Women's Association) in Gujarat, back in 1974.
- Several other associations then grew to provide micro-loans.
- What began as a micro-credit system, slowly altered into a 'financial system' mechanism.
- It soon enabled everyone from rural to urban population to gain access to the micro-loans system in India.
- It was not just limited to banking entities and NGOs but further expanded to non-banking financial entities.

What is the current scenario?

- Given the pandemic situation, there are uncertainties to economic growth in India.
- So, banks shy away from providing loans to the economically backward sections, owing to higher risks.
- But non-banking financial groups continue to provide easy and hassle-free micro loans through an automated process.

How does it work?

- It is done with the help of the application of Machine Learning in the loan procurement and disbursal process.
- The companies can easily access and analyse the borrower's vast digital footprint.
- This helps them to evaluate the loan repayment capacity of an individual.
- The technological term for this form of data is 'alternative data.'
- It is faster to process, unlike the traditional credit score.
- High internet penetration and smartphone availability have also made people aware about the easy process of micro loan procurement.
- In terms of customer support, 'bots' have been specifically designed to answer all the queries of the borrowers with a single click.
- With this rapid development and digitisation, there has been a prominent growth in micro loans acquired by the common people.

- Micro loan helps the unorganised sectors/businesses grow with easy access to credit.
- Besides helping in individuals' growth, micro-finance contribute to the escalation in the growth metrics of the economy as a whole.

5.11 Financial Stability Report July 2021

Why in news?

The Reserve Bank of India recently released its latest Financial Stability Report (FSR).

What is the significance of the FSR?

- The data and information in the FSR allows the RBI to assess the state of the domestic economy.
- The FSR also allows the RBI to assess the macro-financial risks in the economy.
- As part of the FSR, the RBI also conducts "stress tests."
- This is to figure out what might happen to the health of the banking system if the broader economy worsens.
- Similarly, it also tries to assess how factors outside India might affect the domestic economy.

WHAT IS FINANCIAL STABILITY REPORT (FSR)?

- The FSR is published twice each year by the RBI.
- It presents an assessment of the health of the financial system.
- The FSR primarily looks at questions like the following:
  a. Do Indian banks (both public and private) have enough capital to run their operations?
  b. Are the levels of bad loans (or non-performing assets) within manageable limits?
  c. Are different sectors of the economy able to get credit (or new loans) for economic activity?

- E.g. the crude oil prices or the interest rates prevailing in other countries
- Each FSR also contains the results of something called the Systemic Risk Surveys.

What are the highlights of the recent report?

- **GNPAs -** In June 2020, the FSR had noted that Gross NPAs (GNPAs) could rise from 8.5% (of gross loans and advances) at the end of March 2020 to a two-decade high of 14.7% by March 2021.
- The recent FSR has found that the actual level of bad loans as of March 2021 is just 7.5%.
- However, the GNPA ratio of Scheduled Commercial Banks may increase from 7.48% in March 2021 to 9.80% by March 2022 under the baseline scenario.
- Undera severe stress scenario, it could increase to 11.22%, as shown by "macro-stress tests" for credit risk.
- So, the relief provided by the RBI in 2020 has contained the number of Indian firms that openly defaulted on their loan repayment.
- But things could get worse, especially for the small firms (or MSMEs).
- [The relief measures include cheap credit, moratoriums and facilities to restructure existing loans]
- **Regulatory relief and NPA -** A clear picture of NPAs will emerge only when the regulatory relief provided by the RBI is taken away.
- But it is not always clear when a central bank should pull back such regulatory relief.
- Historical experience shows that credit losses remain elevated for several years after recessions end.
- Indeed, in EMEs [Emerging Market Economies], NPAs typically peak 6 to 8 quarters after the onset of a severe recession.
- The longer the blanket support is continued, the higher the risk.
- Because providing excess regulatory relief might help inherently inefficient firms too.
- On the other hand, banks need sufficient buffers to absorb losses along the entire path to full recovery.

- So, support measures cannot be phased out before firms' cash flows recover.
- **Credit growth -** At less than 6%, the overall rate of credit growth in commercial banks is quite dismal.
- What is particularly worrisome is the negligible growth rate in wholesale credit [refers to loans worth Rs 5 crore or more].
- The rate of growth for retail loans (loans to individuals) had become much better in comparison.
- Notably, there was a sharp fall in credit growth much before the Covid pandemic hit India.
- It points to a considerable weakness in demand even before the pandemic.
- This, in turn, suggests that recovery in credit growth may take longer than usual.
- **Systemic Risk Survey (SRS)** - The FSR also published the results of the latest round (April 2021) of the Systemic Risk Survey (SRS).
- It reflects upon the major risks faced by the Indian financial system.
- The risks are broadly classified into five categories - global, macroeconomic, financial market, institutional and general.
- The overall risk perception is "medium."
- However, there were several factors on which experts expected a worrying picture than the one provided in the January 2021 FSR.

5.12 RBI Curbs on Foreign Card Firms

Why in news?

The RBI has so far barred three foreign card payment network companies [Mastercard, American Express and Diners Club] from taking new customers on board, over the issue of storing data in India.

What is the recent decision?

- Recently, the RBI imposed restrictions on Mastercard Asia Pacific Pte Ltd.
- It is kept from onboarding new domestic customers (debit, credit or prepaid) in India.
- The RBI cited as reason the non-compliance with guidelines for storage of data in India.
- It said it had given almost 3 years for Mastercard to comply with the regulatory directions.
- But the firm was unable to complete the process.
- Earlier, the RBI had imposed restrictions on American Express Banking Corp and Diners Club International Ltd, over the same issue.
- **Impact** - Existing customers using credit or debit cards of these firms can continue using the same.
- However, banks and non-banking finance companies that were planning to use these payment networks will now not be able to use these platforms to enrol new customers.
- This leaves only Visa Inc and homegrown NPCI's RuPay as payment providers under no restrictions currently.

What are the RBI guidelines in this regard?

- Funds transferred using debit or credit cards are routed through platforms such as Mastercard, Visa and NPCI.
- These operate under the Payment and Settlement Systems (PSS) Act, 2007.
- Under the Act, the RBI is the authority for the regulation and supervision of payment systems in India.
- As part of this came the RBI circular on Storage of Payment System Data, dated April 6, 2018.
- These guidelines on data storage were to be adhered to within 6 months.
- As per this, all system providers are to ensure that the entire data relating to payment systems operated by them is stored in a system only in India.

- It applies to full end-to-end transaction details, information collected or carried or processed as part of the message or payment instruction.
- They were also required to report on their compliance to the RBI.
- They should also submit a board-approved system audit report conducted by a CERT-In empanelled auditor within the timelines specified.
- [CERT-In - Indian Computer Emergency Response Team.
- CERT-In is a government-mandated information technology (IT) security organization.]

What is the rationale?

- Data access for law enforcement purposes has for long been a challenge.
- So, the idea behind the move is to carry out effective law enforcement requirements.
- In the wake of the rising use of digital transactions, the RBI is particular that the payment systems need closer monitoring.

What are the challenges to compliance?

- Credit and card firms with global operations have been resisting the RBI move.
- They cite as reasons the costs, security risk, lack of clarity, and timeline.
- The RBI had stipulated that data should be stored only in India.
- Also, no copy [or mirroring] should be stored in other countries.
- But payment firms like Visa and Mastercard currently store and process Indian transactions outside the country.
- Their systems are centralised.
- So, they expressed the fear that transferring the data storage to India will cost them millions of dollars.
- Besides, once it happens in India, there is a possibility of similar demand from other countries also.

What is the alternative?

- Possibly, hard localisation may impact India's payments ecosystem.
- For a more effective mechanism for law enforcement, India needs to move beyond the slow and ineffective MLAT (Mutual Legal Assistance Treaty).
- It should move to a system based on bilateral treaties on data transfers with the EU, UK and the US.
- This will ensure that Indian law enforcement requirements of access to data are met in a timely manner.
- It will also allow data flows to foster innovation and trade in the tech ecosystem.
- However, the RBI is against the suggestion that a copy of data stored outside be brought to India.

5.13 End of LIBOR

Why in news?

The London Inter-Bank Offered Rate (LIBOR) nears its end by the end of December 2021.

How does LIBOR work?

- It is Administered by ICE Benchmark Administration (IBA) and regulated by the UK's Financial Conduct Authority (FCA)
- Each day, Intercontinental Exchange asks major global banks how much they would charge other banks for short-term loans.
- It then calculates the average from these

WHAT IS LIBOR & HOW IT WORKS?

- It is a benchmark interest rate at which major global banks lend to one another in the international market.
- It serves for short-term loans with maturities from Overnight to 1 year.
- Each day, Intercontinental Exchange asks major global banks how much they would charge other banks for short-term loans and then calculates the average from these numbers.
- It is based on five currencies including the U.S. dollar, the euro, the British pound, the Japanese yen, and the Swiss franc, and serves 7 different maturity periods

numbers.

- So LIBOR is the average interest rate at which major global banks borrow from one another.
- The combination of 5 currencies and 7 maturities leads to a total of 35 different LIBOR rates calculated and reported each business day.
- It also acts as a basis for Corporate and Government Bonds, mortgages, student loans, credit cards, derivatives and other Financial Products.

What is the recent decision?

- Following scandals in LIBOR (2012) and questions subsequent questions around its validity as a benchmark rate, it is being phased out.
- The FCA confirmed in March, 2021 that 26 LIBOR settings will end on December 31, 2021.
- However, overnight, 1, 3, 6, and 12 Months US Dollar LIBOR settings will end only by June 30, 2023.

Why is this move significant?

- LIBOR is an indicator of the health of the financial system, and provides an idea of the trajectory of impending policy rates of central banks.
- A total of $ 400 trillion of financial products are presently exposed to LIBOR.
- Of this, at least $52 trillion of financial products will still be exposed to LIBOR after December 31, 2021.
- India has about $532 billion of external loans which are exposed to LIBOR.
- So, a transition away from the LIBOR poses certain challenges for banks and the financial system.

Why is LIBOR brought to an end?

Susceptibility to manipulations

- LIBOR's credibility was damaged by rate-fixing scandals in 2012.
- The panel banks submissions were alleged to be inaccurate or manipulated to project market strength.
- All these led to breach of market trust.
- After the 2012 Wheatley Review, a number of reforms were introduced to reduce subjective input and make LIBOR a transaction-based benchmark.
- Thus, IBA became LIBOR's administrator and FCA the supervisory authority for IBA.

Illiquidity

Illiquidity refers to a condition where assets cannot be exchanged for cash easily.

- Despite the reforms introduced, the number of transactions in the short-term wholesale Funding Market reduced over time.
- Because, financial institutions became more reluctant to lend on unsecured basis for terms longer than overnight.
- Thus, LIBOR became more vulnerable to short-term market illiquidity and amplification of price moves that could cause systemic risks.
- Notably, financial transactions are better suited to reference rates that are close to risk free.

What are the alternative reference rates?

- Secured overnight financing rate (SOFR) is being widely used as a substitute for LIBOR across the world.
- SOFR is based on transactions in the US Treasury repo market.
- While LIBOR is an unsecured reference rate (submitted by banks), SOFR is an overnight secured reference rate.
- It is secured because it is transaction-based, collateralized and representative of wholesale borrowing.
- It is administered by the New York Fed that broadly measures the borrowing cash overnight with US treasuries as collateral.

Other Benchmarks rates - (1) CHF - SARON; (2) EUR - ESTER; (3) GBP - SONIA (Already in use since March 31, 2021); (4) JPY - TONA

- All these benchmarks are having an overnight tenor as opposed to LIBOR which had a tenor from overnight to 1 year.

What are the limitations to SOFR?

- Since it is based upon the repurchase (repo) markets, it is at the repo markets mercy.
- In September 2019 a spike in repo rates resulted in SOFR soaring from 2.14% to 5.25% in a single day.

What are the other challenges?

- There are multiple complexities involved in the shifting from LIBOR to another regime
- There could be a lot of volatility in the financial markets as the deadline arrives.
- The RBI has issued two circulars giving the road map to the transition and arrangements to be made for the same.

5.14 M Narasimham's Contribution

What is the issue?

With the demise of M Narasimham, former RBI Governor, it is imperative to reflect on his contribution to reforms in the financial sector.

How did the banking system take in these recommendations?

- **BIS** - The first was bringing in prudential concepts as propounded by the Bank for International Settlements (BIS).
- These were regarding income recognition, capital adequacy, quality of assets, provisioning, etc.
- These concepts took time to digest, and the RBI played a stellar role in bringing them in a calibrated manner so that the system was not disrupted.
- Basel II and Basel III were extensions of the same course.

WHO IS M NARASIMHAM?

- Maidavolu Narasimham (1927-2021) was the thirteenth governor of the RBI [from May 1977 to November 1977].
- He was the only governor of the RBI to have risen to the position from the central bank's ranks.
- He is most recognized for the role he played in liberalizing India's banking and financial system.
- He is rightfully the architect of modern Indian banking.
- What is seen in the banking system today in terms of the struggle to bring about change, had its genesis documented in Narasimham's epochal reports.

- To note, the RBI took time to bring the 90-day concept for recognising non-performing assets (NPAs) so that the system was able to absorb this rule.
- **Private banks** - He had propagated the concept of having more private banks.
- This was a timely recommendation as the system was typified by public sector banks (PSBs), given the shadow of nationalisation.
- Getting in new private banks has brought about a technology revolution in the banking sector.
- They have now permeated all banks, making the system globally comparable.
- Along with this suggestion was the extended frame provided to foreign banks to operate in India.
- There was also a firm signal that there would be no further nationalisation.
- **Interest rates** - The interest rates on deposits and loans were to be freed.
- This was significant because until that point of time all decisions came from the 'above'.

- Here, RBI had gradually moved towards giving banks the freedom to fix their rates on the deposits side.
- However, the lending side is once again back to the fold of partial regulation, with the central bank asking them to follow a formula.
- **CRR & SLR** - The reports argued for sharp reductions in the CRR (Cash Reserve Ratio) and the SLR (Statutory Liquidity Ratio) of banks.
- While banks argue against having a CRR, the system had a rate of 15% in 1989 and again in 1994, after which it has been brought down to 4%.
- The SLR at its peak was at 38.5% in 1990.
- The move to lower these pre-emption reserves owes a lot to the recommendations.
- **Government securities** - The concept of marking-to-market the portfolio of government securities was again a takeaway from the report.
- This was a way of making them market-oriented and also ensuring that the real value of bonds was accounted for by banks.
- **Four-tiered structure of banks** - Narasimham had suggested creating a four-tiered structure of banks, which is seen for the past three decades.
    i. large banks that can be globally competitive
    ii. regional banks that serve specific purposes
    iii. niche banks that cater to communities
    iv. new small banks and payments banks
- This was subsequently strengthened by an RBI committee where differentiated banks were spoken of.
- **Weak banks** - The identification of weak banks and putting conditions was again a concept from the reports.
- It is from this that the RBI has drawn the PCA (Prompt Corrective Action) policy.
- The report suggested ways to tackle such banks and get them out of the mess with narrow banking being an intermediate route.
- **Transparency** - The reports recommended introduction of transparency in bank accounts.
- Today, all annual reports include all disclosures and follow fixed formats.
- It is thus now possible for one to analyse any aspect pertaining to all banks in a uniform manner.
- **Mergers** - The concept of mergers across the financial sector was envisioned in terms of synergies being created.
- The report also spoke of mergers between PSBs, which is now a reality.

What are the key recommendations yet to be fulfilled?

- **Privatisation of PSBs** - This is something that the government is looking at seriously, as per the Union Budget of 2021-22.
- Banks are being targeted for full disinvestment.
- Given that PSBs that have been merged are out of this loop, it looks like the candidates would be smaller ones.
- These may not have the best financials, though are bestowed with strong infrastructure and processes.
- **Remuneration** - The remuneration factor was something that Narasimham had spoken of for PSBs as recruitment was to be made independent.
- There has been no attempt here on the pay structure, which is still a bargaining process.
- The Indian Banks' Association (IBA) plays a vital role here.
- However, in a rather feeble manner, lateral hiring with market-related salaries for specialised posts has come in from the backdoor.
- Now, even some of the large PSBs have a lateral recruit as a CFO.

- **Priority sector** - The reports recommended reducing the amount of lending that had to go to the priority sector from 40% to 10%.
- There has been no change in this regard and it looks unlikely that this issue will ever be discussed.
- Given the political economy, it looks expedient for governments to retain this limit to show that they are pro-poor.
- There can be arguments on the legitimacy of such lending.
- However, the fact is that if 40% of lendable resources are to be directed at pre-decided sectors, there is less flexibility for banks when it comes to lending.
- **Deposit insurance** - The reports had also recommended differentiated deposit insurance premium for banks.
- This is notable because banks carrying a higher risk on their lending portfolio would be made to pay a higher premium for cover on their deposits.
    - [This is based on the CAMELS (capital adequacy, asset quality, management quality, earnings, liquidity, and sensitivity to market risk) score of RBI.]
- This will be quite appropriate to ensure that banks pay more attention to the quality of assets.
- In all, three decades down the road a lot had changed, albeit gradually.
- On the whole, the progress made is satisfying, given the socio-economic conditions in the economy, but structural changes take time.

6. MONEY MARKET

6.1 Increase in outstanding P-notes

Why in news?

P-notes (Participatory notes) hit a 31-month high in November 2020, with the value of outstanding P-notes reaching Rs. 83,114 crore.

What are the recent developments?

- P-notes have gained notoriety on account of their rampant misuse prior to 2008.
- The value of outstanding P-notes had exceeded 50% of FPI assets in late 2007.
- This led to SEBI clamping down on the issuances of, and disclosure and trading in, these instruments.
- Outstanding P-notes have reduced sharply since then.

WHAT ARE P-NOTES?

- Foreign portfolio investment (FPI) is a common way to invest in overseas economies.
- It includes securities and financial assets held by investors in another country.
- P-notes are issued by foreign portfolio investors (FPIs) registered with SEBI to overseas investors who are not registered as FPIs in India.
- In this, the final owner can be concealed from regulators.
- This anonymity provided by P-notes had led to entities using this route to round-trip funds.

Is increase in outstanding P-notes a problem?

- There is no real cause for alarm in the value of outstanding P-notes increasing.
- These instruments account for only 2% of FPI assets currently.
- The increase in value of outstanding P-notes can be explained by two factors:

1. the rally in stock prices has resulted in inflating the value of existing P-note holdings
2. there has been a great surge in FPI inflows this fiscal, with investments so far exceeding Rs. 2,42,000 crore

- So, increase in outstanding P-notes implies higher overseas demand for Indian stocks.
- Despite the impact of the pandemic on the economy, foreign investors have preferred Indian equities.
- This is due to the country's demographic advantage and its consumption-led growth.
- Foreign investors already registered with SEBI can easily increase their investments into the Indian market at such times.
- But, those yet to obtain registration may prefer the P-note route for its speed and lower compliance requirements.
- It further needs to be noted that there are no P-notes issued on derivatives outstanding now.
    - Derivatives are securities that derive their value from an underlying asset or benchmark.
    - P-notes on derivatives are the riskiest.
    - This is because they are used by hedge funds and large traders in the international market who tend to move in and out of stocks very rapidly.
    - This may cause great volatility in stock prices.
- Since no P-notes issued on derivatives outstanding now, SEBI need not worry about scrutinising the P-note inflows or tightening the rules governing these instruments.
- However, this cannot be said about rules governing FPIs.

6.2 Uncertainty in stock market indices

Why in news?

- With the Union Budget just five days away, Sensex fall by 938 points & NSE Nifty Index by 271 points.
- With this, the Sensex has fallen 2,600 points after it hit the 50,000 mark last week.

What has led to this selling pressure?

- After a weak start, the benchmark indices gradually drifted lower as the day progressed and settled around the day's low.
- Several factors- negative foreign flows, uncertainty about US stimulus, US FOMC (Federal Open Market Committee) meeting & less encouraging earnings announcements affected the market.
- Besides this caution ahead of the Union Budget and scheduled derivatives expiry also added to this dip.
- All the other indices, barring FMCG, ended in loss with metal,auto remaining the top losers.

Are foreign investors selling stocks?

- Foreign portfolio investors (FPIs) who invested Rs 1.70 lakh crore in 2020 have turned cautious & it is well-known that fall in FPIs inflows is the biggest risk to the liquidity-driven rally.
- Indian stock market mirrored a mixed sentiment from global peers & downward rally is owed to the consecutive days of FPI selling.
- Barring the defensive FMCG segment, all sectors traded in the red zone with banking and pharma stocks being the worst hit.

How are other markets performing?

- The global markets had mixed values ahead of the US Fed meeting & amid uncertainty over the US stimulus.
- In the Asian session, shares fell due to some profit-taking as investors grew wary of stretched valuations.
- Europe's share indexes opened lower, while investors focused on the US Federal Reserve meeting and US tech giants' earnings.

- Besides, worries over the Covid pandemic and economic recovery have made investors cautious.

What are the issues ahead for the markets?

- The markets are eagerly awaiting the Union Budget scheduled on February 1 & are worried about the impact of Covid on fiscal deficit and the borrowing programme.
- Besides, there are worries over new tax proposals of the government which is seeking new revenue sources.
- FPIs are expected to take a view after considering the US stimulus programme which is yet to be formalised.
- Global investors are also awaiting the statement of the US FOMC about the economy and interest rates.
- A major reason for the global stock rally all these months was a liquidity surge in most countries including India.
- The RBI in its bi-monthly monetary policy is expected to give an indication about the policy stance and the way forward on the unwinding of the accommodative policies.

Will the FOMC meeting impact markets?

- The US Federal Reserve is expected to be more cautious about the near-term outlook, while more optimistic over the longer-term.
- Investors mainly focus on the message that the central bank provides.
- It is expected that central bank will reiterate its accommodative stand & tapering of asset purchases will not be the policy agenda even if new fiscal program are introduced.
- The upcoming FOMC meeting is most likely to leave the policy rate unchanged at 0-0.25% & expected to reinforce accommodative stand as US economy continues to battle the pandemic.
- Over the last week, many major central banks -ECB, BoJ, BoC- continue to provide assurances that monetary policy will remain accommodative for a considerable period of time.

6.3 National Stock Exchange Glitch

Why in news?

Recently, trading on National Stock Exchange (NSE) got halted due to a technical glitch.

Why it got halted?

- NSE accounts for 100% of equity derivative trades and almost 90 % of cash trades in equity.
- Its trading got halted due to issues with telecom links and trade did not migrate to the disaster recovery (DR) site immediately.
- NSE said that it has multiple telecom links with two service providers to ensure redundancy.
- But all the links became unstable in the same time thereby impacting the risk management system.
- NSE reported that there was no impact on the trading system and trading hours got extended till 5 pm on the BSE, NSE and MSEI.

What was the impact of this halt?

- Since February derivative contracts will get expired in the following day, those who held derivative positions got grieved due to the uncertainty in trade resumption.
- They also suffered losses on option contracts.
- Due to the gap in communication, intra-day trading positions got forcibly sold in BSE which resulted in loss for smaller traders.

How should the Regulator respond now?

- The Regulator-SEBI should expedite the investigation behind the halt and take stern action which can act as deterrent for any future lapses.
- It should soon frame rules for compensating investors in such events.
- SE needs to be enquired why it did not communicate clearly to its investors about restart of the trading.

- A stress test needs to be carried on the exchange platforms to check whether they can handle such heavy load around the derivative expiry period.

6.4 Bear Market

Why in news?

Recently investors sold off stocks across the board leading to fall in the stock market indices.

What led to the sell-off in Indian market?

- Earlier, US 10-year bond yield climbed to 1.614% which was highest in a year due to concerns over inflation in the country.
- Due to this US Federal Reserve had to either lower the monthly bond-buying or to hike the interest rates.
- This affected the India markets as it is the major recipient of foreign inflows.
- The rising crude oil prices and increasing geopolitical tension between US and Syria also raised concerns among the investors.
- Moreover GDP data for the 3rd quarter which is yet to be released is also adding volatility to Indian market.

How do Indian markets further respond?

- Investors will keenly monitor the data like auto sales numbers and manufacturing PMI and services PMI.
- But the rising bond yields continue to remain a key concern for equity markets worldwide despite positive statements by US Fed.
- It is expected that there will be further decline in the indices.

Is the bull market over?

- Though markets are witnessing volatile movements they are not expected to fall further.
- Indian markets have witnessed a positive performance in the earlier months due to strong foreign flows, improvement in the macroeconomic fundamentals and corporate earnings growth.
- Therefore conditions for a structural bull market remain intact in India.
- Hence long-term investors will use this opportunity to take advantage of volatility and accumulate quality businesses at reasonable valuations and price points.
- The market will gain momentum when global market gets stabilised.
- This will be achieved by maintaining accommodative monetary policy and a positive growth.

6.5 Silicon Valley Start-up Robinhood

Why in news?

- The online trading app Robinhood became a cultural phenomenon in Silicon Valley with being one of the hottest venues in the past week's retail-trading frenzy.
- But it abruptly blocked clients from purchasing shares of some companies whose stock prices had spiked dramatically and shaken up Wall Street.

How did Robinhood evolve?

- Robinhood is a trading platform operated by American financial services company Robinhood Markets Inc.
- It is a broker-dealer registered with the United States Securities and Exchange Commission.
- The company is headquartered in Menlo Park, California.
- It was founded in April 2013 by Vladimir Tenev and Indian American Baiju Bhatt.
- Both of them are now co-chief executive officers of the company.
- Robinhood's revenue comes from interest earned on customers' cash balances, margin lending and selling order information to high-frequency traders.

- The platform is believed to have had 13 million users in 2020.
- It came with a promise to wrest the stock market away from Wall Street's traditional gatekeepers and "let the people trade."

What happened now?

- Many of the small investors were on a mission to challenge the dominance of Wall Street.
- They thus used Robinhood's free trades.
- Investors on Robinhood, who had been buying up options and shares of GameStop, a video game retailer, enlarged those bets.
- Rampant speculation on options contracts helped drive the rise of GameStop's shares from about $20 on January 12, 2021 to nearly $500 in less than 20 days.
- Investors also began making big trades in other stocks, including AMC Entertainment.
- The trade frenzy thus morphed into a crisis.

What did the firm do?

- As the trading mania grew, the financial system's risk reduction mechanisms kicked in.
    - The mechanism is managed by obscure entities at the center of the stock market called clearinghouses.
- This forced Robinhood to find emergency cash to continue to be able to trade.
- It had to stop customers from buying a number of heavily traded stocks and draw on a more than $500 million bank line of credit.
- The company also took an emergency infusion of more than $1 billion from its existing investors.

What was the clearinghouse's role?

- One institution that tripped up Robinhood in the recent episode is a clearinghouse called the Depository Trust & Clearing Corp (DTCC).
- It is owned by its member financial institutions including Robinhood.
- The DTCC clears and settles most stock trading, essentially making sure that the money and the shares end up in the right hands.
    - Options trades are cleared by another entity.
- But the DTCC's role is more than just clerical.
- Clearinghouses are supposed to help insulate a particular market from extreme risks.
- It does this by making sure that if a single financial player goes broke, it doesn't create a contagion.
- To do its job, the DTCC requires its members to keep a cushion of cash that can be put toward stabilizing the system if needed.
- When stocks are swinging wildly or there's a flurry of trading, the size of the cushion it demands from each member, known as a margin call, can grow on short notice.
    - In the recent event, the DTCC notified its member firms that the total cushion, which was then $26 billion, needed to grow to $33.5 billion, within hours.
    - As Robinhood customers were responsible for so much trading, it was responsible for footing a significant portion of the bill.
- The DTCC's demand is not negotiable.
- A firm that cannot meet its margin call is effectively out of the stock trading business because DTCC will not clear its trades any more.
- For a start-up like Robinhood, generating additional hundreds of millions of dollars on short notice is a big deal.

What was the response?

- The company ended up creating risk for their customers and systemic risk for the market more broadly.
- Users flooded online app stores with hurtful reviews, with some accusing Robinhood of doing the bidding of Wall Street.
- Others sued the company for the losses they sustained.
- On the other hand, even as Robinhood's actions angered existing customers, it was winning new ones.
- The Securities and Exchange Commission said that it would closely review any actions that may "disadvantage investors or otherwise unduly inhibit their ability to trade certain securities."
- While Robinhood arranged for the needed cash from its credit line and investors, it limited its customers from buying GameStop, AMC and other shares.
- Allowing its investors to sell the volatile stocks, but not buy them, reduced Robinhood's risk level and helped it meet requirements for additional cash.
- Notably, the deposit requirements had increased tenfold during the week.

What was unique with Robinhood and what impact did this create?

- The two who created the company in 2013 said from the beginning that their focus was on "democratizing finance" by making trading available to anyone.
- To do so, the company has repeatedly employed a classic Silicon Valley formula of user-friendly software, brash marketing and a disregard for existing rules and institutions.
    - E.g. online brokers had traditionally charged around $10 for every trade
    - But Robinhood said that customers of its phone app could trade for free.
    - The move drew in hordes of young investors.
- Robinhood also popularized options trading among new investors.
    - An option is generally cheaper than buying a stock outright.
    - But options trading has the potential to lead to much bigger and faster gains and losses.
    - This was why regulators and brokers have traditionally restricted trading in these financial contracts to more sophisticated traders.
- In building its business this way, the company disregarded academic research.
- It thus ignored propositions showing how frequent, frictionless trading generally does not lead to good financial outcomes for investors.

6.6 Archegos Share Dump

What is the issue?

- Archegos Capital Management, a private investment firm based in New York, resorted to a huge fire sale of stocks worth $20 billion.
- This had caused widespread fears in the global financial market, reminding of the 'Lehman crisis.'

What is the sell-off all about?

- Archegos Capital Management is a private investment firm based in New York.
    - Archegos was founded by Bill Hwang.
    - He founded and ran Tiger Asia from 2001 to 2012, when he renamed it Archegos Capital and made it a family office.
    - Tiger Asia was a Hong Kong-based fund.
- Archegos Capital Management recently resorted to a huge fire sale of stocks worth $20 billion.
- The fund had large exposures to Viacom CBS and several Chinese technology stocks.
- It was hit hard after shares of Viacom CBS (US media group) began to tumble.

- The decline in stock prices prompted a *margin call* from one of Archegos's prime brokers.
- This triggered similar demands for cash from other banks.
- Traders were braced for further block sell-offs in stocks associated with Archegos and other funds that could also be forced to unwind heavily leveraged positions.

What is a margin call?

- Typically, a margin call occurs when the value of an investor's margin account falls below the broker's required amount during a market correction or sell-off.
- The margin account contains securities bought with borrowed money.
- A margin call is usually an indicator that the securities held in the margin account has decreased in value.
- So, lenders demand that an investor deposit additional money or securities into the account so that it is brought up to the minimum value.
- The investor must thus choose to either deposit more money in the account or sell some of the assets held in their account.
- If the investor fails to pay up the margin amount, the lender will resort to sale of assets lying in the investor's account.
- The huge margin call on Archegos was the major driver behind the recent steep sell-off and the subsequent hits to several global bank balance sheets.

What is the impact of the sale?

- The sale caused big drops in the share prices of companies linked to the investment firm.
- This has put markets on the edge about the scale of the possible fallout, raising fears of a possible "Lehman moment".
    - The 'Lehman crisis' is associated with the bankruptcy of the giant Lehman Brothers Holdings, a global financial services firm in the U.S.
    - This happened in September 2008.
    - This was the biggest ever bankruptcy, that triggered a wave of bailout measures from the Federal Reserve and the US Treasury to save the economic structure.
- In that case, the event would force multiple lenders - mainly Credit Suisse and Nomura - to suffer huge losses.
- The problems at Nomura and Credit Suisse is possibly related to being slower in offloading share blocks into the market compared with their peers.
- Nomura said that it faced a possible $2 billion loss due to transactions with a US client.
- Credit Suisse said a default on margin calls by a US-based fund could be "highly significant and material" to its first-quarter results.
- Credit Suisse is estimated to have lost between $3 bn and $4 bn.

6.7 SEBI's New AT1 Bond Norms

Why in news?

- Securities and Exchange Board of India (SEBI) has slapped restrictions on mutual fund (MF) investments in additional tier-1 (AT1) bonds.
- This has raised concerns in the MF and banking sectors, and the Finance Ministry has asked the SEBI to withdraw the changes.

What is SEBI's recent decision and why?

- In a recent circular, the SEBI told mutual funds to value the perpetual AT1 Bonds as a 100-year instrument.
- This essentially means MFs have to make the assumption that these bonds would be redeemed in 100 years.

- The regulator also asked MFs to limit the ownership of the bonds at 10% of the assets of a scheme.
- The RBI recently allowed a write-off of Rs 8,400 crore on AT1 bonds issued by Yes Bank Ltd after it was rescued by State Bank of India (SBI).
- The SEBI has probably made the decision after this.
- According to the SEBI, these instruments (AT1 Bonds) could be riskier than other debt instruments.

WHAT ARE ADDITIONAL TIER (AT)-1 BONDS?

- These are unsecured bonds which have perpetual tenure. which means the bonds have no maturity date.
- They have call option, which can be used by the banks to buy these bonds back from investors.
- They are typically used by banks to bolster their core or tier-1 capital.
- Mutual funds (MFs) are among the largest investors in these perpetual debt instruments.
- MFs hold over Rs 35,000 crore of the outstanding AT-I bond issuances of Rs 90,000 crore.

How will MFs be affected?

- Typically, MFs have treated the date of the call option on AT1 bonds as maturity date.
- Now, if these bonds are treated as 100-year bonds, it raises the risk in these bonds as they become ultra long-term.
- This could also lead to volatility in the prices of these bonds as the risk increases, the yields on these bonds rises.
    - Bond yields and bond prices move in opposite directions.
    - Therefore, higher yield will drive down the price of bond.
- This, in turn, will lead to a decrease in the net asset value of MF schemes holding these bonds.
- Moreover, these bonds are not liquid and it will be difficult for MFs to sell these to meet redemption pressure.
- Potential redemptions on account of this new rule would lead to mutual fund houses engaging in panic selling of the bonds in the secondary market.
- This again will lead to widening of yields.

What is the impact on banks?

- AT1 bonds have emerged as the capital instrument of choice for public banks as they strive to shore up capital ratios.
- If there are restrictions on investments by mutual funds in such bonds, banks will find it hard to raise capital.
- It becomes especially hard at a time when banks need funds in the wake of the soaring bad assets.

Why has the Finance Ministry called for a review?

- The Finance Ministry has sought withdrawal of valuation norms for AT1 bonds prescribed by the SEBI for mutual fund houses.
- The Ministry feels that the decision might lead to mutual funds making losses and exiting from these bonds.
- That would affect capital raising plans of PSU banks.
- Two PSU banks are on the privatisation block.
- Also, banks are yet to receive the proposed capital injection in FY21 although they will need more capital to face the asset-quality challenges in the foreseeable future.
- Given these, the government does not want a disruption in the fund mobilisation exercise of banks.

6.8 Bond Yield, GDP and GVA

What is the issue?

- As the Covid-19 vaccines are rolled out, economic activity is gaining momentum.
- So, investors are moving away from government bonds thereby increasing the bond yields.

What are Bond Yields?

- A bond is a debt instrument which governments sell to raise fund for meeting its expenditure.
- These bonds have a selling price and a fixed coupon rate.
- Bond yield is the return an investor realizes on a bond and it is inversely proportional to the bond price.

How does Yield vary with the economy?

- If investors are apprehensive about the economy, they will invest in government bonds as it is the safest form of investment.
- In such cases, the demand for government bonds will rise and so will their prices and yield will fall down.
- If investors have positive view about the economy, they move away from government bonds, which results in a fall in bond prices and increase in yields.

How does Indian Stock Market get affected by this yield variation?

- With the arrival of Covid-19 vaccines in the US, economy is regaining its pace so investors move away from government bonds.
- But US bond yields are influential and seen as safest one in the global market hence they attract funds from investors across the world increasing the bond yields.
- Hence the US central bank will raise interest rates to contain inflation as economic growth takes off now.
- Now Global investors will pull out money from emerging economies such as India and invest in US bonds which affect India's domestic stock markets negatively.
- But the yields of Indian G-secs have also got raised in line with US bond yields.
- This means that investors find lending to the Indian government a better alternative than lending to the Indian firms.

How is GDP different from GVA?

- GDP is the total amount of money spent in an economy and GVA is the value added (in money terms) by economic agents in each sector of the economy.
- GVA is more relevant to map the performance of the domestic economy from one quarter to another.
- In fact in a year, GVA data is made available first and GDP is arrived at by taking the GVA and adding all the government taxes and subtracting all the government subsidies.
- This implies that for the same level of GVA in an economy, the GDP could alter just because the government earned more money from its taxes or spent more on subsidies.
- In other words, to have a better picture about the true state of India's economic revival GVA should be used.

What does Second Revised Estimates mention about this?

- As per the Ministry of Statistics and Programme Implementation Second Revised Estimates (SAE), India's GDP is expected to contract at 8% when compared to 7.7% in the First Estimate.
- This means that India's per capita GDP, per capita private consumption and the level of investments in the economy are expected to fall to a level which was seen in 2016-17 or earlier.
- The GDP growth rate is revised down and GVA growth rate is revised up.
- It also expects the industry and the services sectors to contract but the pace of contraction is lower than what was expected in January.
- This indicates that India economy is on a recovery phase even though the GDP growth rate got worsened.

6.9 Sovereign Gold Bonds

Why in news?

Recently the Reserve Bank of India (RBI) has announced a plan to sell sovereign gold bonds (SGBs) in six phases.

What are Sovereign gold bonds?

- Sovereign gold bonds are issued by the RBI on behalf of the government.
- They are government securities denominated in grams of gold which are substitutes for holding physical gold.
- In 2015, sovereign gold bond scheme was launched with an objective is to reduce the demand for physical gold and shift a part of the domestic savings (used for the purchase of gold) into financial savings.

What are the terms of the issue?

- The Sovereign Gold Bond Scheme 2021-22—Series I will be open for subscription for the period May 17-21, 2021.
- This will be followed by Series II (May 24-28), III (May 31-June 4), IV (July 12-16), V (August 9-13) and VI (August 30-September 3).
- The nominal value of the 8-year bond is Rs 4,777 per gram of gold, based on the simple average closing price on the last three business days of the week preceding the subscription period of Series I.
- There's a discount of Rs 50 per gram to investors when applied online and the payment against the application is made through digital mode.
- Gold bonds bear interest at a fixed rate of 2.50% per annum on the amount of initial investment which will be credited semi-annually.
- These bonds are sold through offices or branches of nationalised banks, private banks, foreign banks, designated post offices, Stock Holding Corporation of India Ltd., the authorised stock exchanges etc.

What are the minimum and maximum limits for investment?

- The bonds are issued in denominations of 1 gram of gold and in multiples thereof.
- The minimum investment will be 1 gram, with a maximum limit of subscription of 4 kg for individuals, 4 kg for Hindu Undivided Family (HUF) and 20 kg for trusts.
- Government notifies other similar entities from time to time per fiscal year (April–March).

Can these securities be used as collateral for loans?

- They can be used as collateral for loans from banks, financial Institutions and non-banking financial companies (NBFC).
- The loan-to-value ratio will be the same as applicable to ordinary gold loans prescribed by RBI from time to time.
- Granting loans against SGBs would be subject to the decision of the bank/financing agency, and cannot be inferred as a matter of right.

What are the tax implications?

- Interest on the bonds will be taxable as per the provisions of the Income-Tax Act, 1961 (43 of 1961).
- But the capital gains tax arising on redemption of SGB to an individual has been exempted.
- Indexation benefits will be provided to long-term capital gains arising to any person on transfer of bonds.
- Though TDS is not applicable on the bonds, but it is the responsibility of the holder to comply with tax laws.

What will investors get on redemption?

- Investors gain from appreciation in gold prices as redemption of bonds will be based on the then prevailing prices.
- If gold prices rise, the investor will get the higher prices plus the 2.5% interest and vice-versa.
- On maturity, the gold bonds will be redeemed in Indian rupees and the redemption price will be based on a simple average of closing price of gold of the previous 3 business days from the date of repayment.

- Although the tenure of the bond is 8 years, early redemption of the bond is allowed after the fifth year, on coupon payment dates.
- The bond will be tradable on exchanges, if held in demat form and can also be transferred to any other eligible investor.

Why should investor buy gold bonds rather than physical gold?

- The quantity of gold the investor pays for is protected, since he receives the ongoing market price at the time of redemption/premature redemption.
- These bonds offer a superior alternative to physical gold as the risks and costs of storage are eliminated.
- Investors are assured of the market value at the time of maturity, and periodical interest.
- Also these bonds are free from issues like jewellery making charges and purity, risk of loss of scrip etc.

6.10 Gold Standard

Why in news?

TheInternational Bullion Exchange is being established in Gujarat International Finance Tec-City.

Why there is a need for establishing this exchange?

- Due to the absence of spot market for gold, domestic stakeholders were forced to use prices traded on international exchanges for computing local prices.
- So a MOU was signed between the leading stock and commodity exchanges and depository participants.
- This paved way for establishing the market infrastructure for the bullion exchange.

How are the prices determined until now?

- Currently there is no transparency in determining the local price of gold.
- It is decided by the Indian bullion and jewellers association based on buy and sell quotes from ten of its biggest dealers.
- These dealers then convert the international gold price to rupee, add taxes and their commission to quote the price.
- This method of price fixing is vulnerable to manipulation as witnessed in countries such as the UK.
- With the establishment of this exchange, transparency will get imparted in determining the local price of gold.
- Also a strong bullion exchange in the IFSC will help jewellers and retailers to buy gold directly from foreign traders instead of using banks as intermediaries.

What are the benefits of this exchange?

- In the international bullion market, India will soon become a price setter from being a price taker.
- The exchange will help in better price discovery of bullions.
- It will facilitate in trading the bullion spot delivery contract and spot depository receipt.
- It has Bullion vaulting services which facilitates in storing the gold traded at the offshore exchange.
- This exchange can also become a future hub of gold trading if international traders are incentivised enough to shift part of their trading here.

Who will regulate the exchange?

- In India, most of the spot commodity markets features in the State list and are beyond the purview of SEBI.
- So the International Financial Services Centres Authority has been given the responsibility of supervising the implementation and operations of the exchange.
- This is done according to the IFSCA (Bullion Exchange) Regulations, 2020.

What are the issues present in this process?

- It is not easy to attract foreign companies who trade gold in other offshore centres to the domestic exchange.

- IFSCA has to provide enough incentives -lower transaction cost and other benefits -to make them shift to the GIFT IFSC.
- Also there is no clarity whether retail clients can sell their gold at this exchange.
- If their participation is enabled, then gold assaying centres needs to be up at IFSC along with regulatory changes.

6.11 Special Purpose Acquisition Companies

Why in news?

Recently, International Financial Services Authority sought the views of the public on listing the securities of Special Purpose Acquisition Companies on the GIFT IFSC.

What are the merits on listing new securities?

- IFSCA is right in its consideration to introduce new categories of securities in the IFSC.
- These securities can be issued by an unlisted issuer or a follow-on public offer of specified securities by a listed issuer or listing of specified securities by a start-up company or an SME.
- If the pool of investors at the IFSC increases, it will help domestic entities raise funds easily.
- Moreover listing of debt securities including ESG focussed debt securities can enhance the reputation of the IFSC.

What is the issue in expanding the base of securities?

- IFSCA ruled that sponsors will hold at least 20% of the post-issue capital and suggested a minimum application of $250,000 to protect the investors from risk of loss.
- If tight monetary condition prevails, the desire for these products will reduce which might cause losses to investors.
- Moreover increasing the acquisition timeline to four years from three years is considered too long.
- If any of the issuers fail to make the intended acquisitions, it may impact the credibility of the GIFT-IFSC.
- Though IFSC intends to expand the range of securities traded in the offshore centre but it should be mindful of not eroding the credibility of the centre.
- Given the GIFT-IFSC is in at a very nascent stage of development, it is best not to introduce this in the GIFT-IFSC.

WHAT IS SPECIAL PURPOSE ACQUISITION COMPANIES (SPACS)?

- SPACs are shell companies that raise money with the intention to acquire an existing company from the funds raised in the public offer.
- These companies don't have existing business and investors in these issues bet on future acquisitions which give them due returns.
- Like crypto currencies, the company assets don't have any intrinsic value at the time of the issue.
- Investors just rely on the reputation of the sponsor and his expertise in identifying the right company for acquisition.
- In recent times they are gaining popularity due to the increasing global liquidity levels on the prices of risky assets.

6.12 US Taper Tantrum Policy

Why in news?

The manner in which the US Federal Reserve (Fed) is easing the financial market is suggestive of the taper tantrum trends of 2013.

What is the taper tantrum of 2013?

- After the 2008 global financial crisis, to increase money supply in the economy, the US Fed introduced Quantitative easing programmes.
- All of them aimed at increasing lending by commercial banks and spending by consumers.
- US economy and labour market conditions recovered well after 2010.
- Eventually, the Fed began considering exit from the easy money policy by the end of 2013.
- So, the Fed followed Tapering i.e a system of slowly reducing the amount of money the Fed puts into the economy.

What was the impact?

- The US Fed's announcement in 2013 led to a sudden sell-off in global stocks and bonds.
- Because, when yields on the ultra-safe US treasuries rise, investors have reduced incentive to invest in riskier assets such as equity. [Click here to know more on bond yield-price relation.]
- US stock market dropped around 4% immediately after the announcement.
- Bond yields surged.
- The impact was felt globally as foreign investors pulled money out of bonds of emerging economies, creating.
- This triggered capital outflows and currency depreciation in many emerging market economies including India.
- The subsequent widening of current account deficit (CAD) eroded the forex reserves that the RBI had built till then.

What is the apprehension now?

- In the wake of the pandemic and its economic implications, U.S. Fed started massive bond-buying programmes in 2020 to infuse liquidity.
- It also pushed down the interest rates, to allow banks to offer cheaper loans, thereby stimulating economic activity.
- Now, with economic recovery, the US Fed is aiming for a gradual reduction of this quantitative easing programme.
- This has led to fears that the move could resemble the "taper tantrum" of 2013.

What is the likely impact?

- **Global Investments -** Almost half of the global investor funds originate in the US.
- So, the Fed funds rate is critical for global investors due to the asset buying sentiment fuelled by the ultra-low interest rates in the US.
- Once rates begin moving up, investors who have borrowed in dollars to invest in assets globally will sell these assets to pay back the dollar loans.
- This can, in turn,de-stabilise markets.
- **India -** The biggest impact will be seen in FPI flows.
    1. FPI flows shrunk from 2015 to 2018 when the Fed was tightening its monetary policy.
    2. In contrast, the net inflow was more than Rs.1,70,000 crore in 2020, linked largely to Fed funds rate being close to zero.
    3. Now, again, FPI money is likely to move back to US treasury securities.
- Also, the Indian G-secs and the rupee could witness volatility once the Fed rate hike cycle begins.
- Nevertheless, the impact on Indian equities may be negligent, as seen during the first taper (2013).
- That's because domestic institutional investors such as mutual, insurance and pension funds can step up the buying.
- Also, with retail investors in place, large FPI outflows may not hurt the market much.

- The Fed officials have also said that they were trying to be as transparent as possible about their plans to avoid a repeat of the 2013 event.

6.13 SEBI's Consent Mechanism

Why in news?

SEBI has decided to review and propose refinements to the regulation of consent mechanism in order to tighten the process.

What is the Consent Mechanism of SEBI?

- SEBI introduced a settlement mechanism for violation of securities laws in India in the year 2007.
- Later the SEBI (Settlement of Administrative and Civil Proceedings) Regulations, 2014 (Settlement Regulations 2014) were notified to bring in certainty of legal enforceability in the system.

What changes have been proposed to the procedural aspects of settlement?

- **Shortening the timeline** allowed for market participants served with show-cause notices to apply for settlement.
  - Present regulations allow participants an additional 120 days after receiving show-cause notice on top of a 60-day initial period to apply for a settlement.
  - The proposal fixes the deadline at 60 days and the time given to pay up settlement proceeds is being cut short to 30 days instead of 90.
- **Reduction of settlement amount** - Based on the timing of filing for settlements, the amount will be reduced.
- **Settlement amounts –** The settlement amounts are presently based on the status of the violators.
- For the same instance of fraud, an individual may be allowed to settle for Rs.15 lakh while a company may need Rs.1 crore.
- The paper argues that settlement amounts should be based on culpability instead of identity.

Does the proposed changes look optimistic?

- Shortening the timeline to apply for settlement prevent violators from delaying settlements.
- Reduction of settlement amount based on the timing of filing of settlements will nudge market participants to file for settlement at the early stages of proceedings and reduces SEBI's caseload.
- Settlement amounts based on culpability will help in filtering the actual perpetrators from other entities such as dummy directors, mule accounts and individuals with inactive bank accounts.
- But, discretionary powers enjoyed by SEBI to accept or reject offers for settlement remain a grey area because it is subjective to varying interpretations.
- To render the consent mechanism more credible, SEBI needs to **transparently** disclose its criteria for accepting or rejecting settlement offers and strive to better codify these into law.

3.8 Government Securities Acquisition programme

Why in news?

In its recent monetary policy briefing, the RBI announced of Rs one lakh crore Government Securities Acquisition programme (G-SAP 1.0.)

What is G-SAP?

- The RBI periodically purchases Government bonds from the market through Open Market Operations (OMOs).
- The G-SAP is in a way an OMO.
- But there is an upfront commitment by the RBI to the markets that it will purchase bonds worth a specific amount.
- The idea is to give a comfort to the bond markets.

- In other words, G-SAP is an OMO with a 'distinct character.'

What is the rationale?

- The governmentwill mainly be benefited from the G-SAP 1.0. operations.
- The government, notably, has a massive borrowing programme scheduled for FY22.
- It has planned a Rs 12.05 lakh crore borrowing plan for fiscal year 2022.
- So, the RBI's endeavour is to keep the yield down, to lower the borrowing cost of the Government.
- The plan is to enable a stable and orderly evolution of the yield curve amidst comfortable liquidity conditions.
- The endeavour will be to ensure congenial financial conditions for the economic recovery to gain traction.
- For Q1 of 2021-22, therefore, it has been decided to announce a G-SAP of Rs One lakh crore.
- Also, the positive externalities of G-SAP 1.0 operations need to be seen in the context of those segments of the financial markets that rely on the G-sec yield curve as a pricing benchmark.

What is the first phase of operation?

- The RBI has officially notified that it would conduct the first phase of G-SAP 1.0 operations on April 15, 2021.
- It will begin with the purchase of five dated securities for an amount aggregating to Rs25,000 crore.
- The first phase of G-SAP purchase will happen using the multiple price method under which the bidders pay at the respective rate they had bid.
- The RBI has notified four securities for the G-Sec purchase in different maturities.
- In addition to the G-SAP plan, the RBI will also continue to deploy regular operations.
- This would be under the LAF, longer-term repo/reverse repo auctions, forex operations and open market operations including special OMOs.
- This is to ensure that the liquidity conditions evolve in consonance with the stance of monetary policy.

What are the concerns?

- **Interest rates** - For the Government, the RBI keeping the yield downis a good news because the overall borrowing costs go down.
- But,the RBI artificially keeping the interest rates lower in the financial system has caused concerns.
- In healthy economic system, the interest rates pricing should be driven by demand-supply.
- It shouldn't be artificially suppressed by the central bank; this might lead to distortions and have other consequences.
- **Savers -** Cheaper rates will be good news to big, top rated companies who can issue bonds to raise money and to the government.
- But low interest rates coupled with high inflation is a systemic worry for savers.
- Already, savers are getting negative returns on their deposits if one takes into account the inflation adjusted rates or real rates.
- **Rupee** - Government resorting to massive bond purchase to keep the rates low is not good news for the local currency.
- The Indian Rupee, notably, came under pressure after the RBI announced the massive Rs 1 lakh crore bond purchase programme.
- The fear of investors pulling capital out of India in a low interest environment is hurting the local currency.

7. EXTERNAL SECTOR

7.1 Forex Reserves Soar

What is the issue?

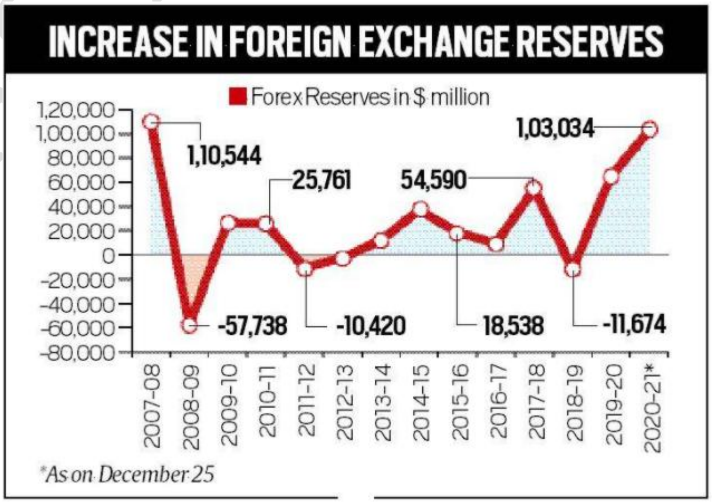
- India's foreign exchange reserves have risen by over $103 billion as of 25 December 2020 which is set to surpass the all-time-high increase of $110.5 billion recorded in 2007-08 by end of the fiscal.
- Though the reserve positions are comparable, the context between the official reserve accretion then and now is different.

Why is it totally different now from 2007-08?

- In 2007-08, the economy was booming, registering a GDP growth of 9.3% on top of 9.6% and 9.5% in the preceding 2 years.
- The Centre's fiscal deficit, too, was a mere 2.5% of GDP.
- India could, then, easily withstand the shock from the global economic crisis that followed one year later.
- In contrast, the economy has now contracted by 14.9% year-on-year in April-September 2020-21.
- The RBI expects growth for the whole fiscal to be -7.5% (on top of a dismal 3.9% for 2019-20). Nor are government finances in great shape.
- The most optimistic projection of the Centre's fiscal deficit for 2020-21 stands at 6.5%-7% of GDP (as against the budgeted 3.5%).

How about the contributing factors?

- In 2007-08, the $110.5-billion reserve build-up amounted to 7.4% of India's then much-smaller GDP.
- Importantly, it was powered largely by foreign investment, external commercial borrowings and other capital inflows totalling $107.9 billion.
- These inflows were more a result of 'pull' factors, having to do with global investors wanting to partake of the India growth story.
- In contrast, the forex reserve accumulation in 2020-21 has been driven mainly by current account balance (exports-imports gap) turning positive at $34.7 billion during April-September 2020.
- This surplus has, in turn, been due to imports in April-September 2020 falling by a massive $95.6 billion over April-September 2019.



- This is further reflective of low import demand in a shrinking economy.
- The current account surplus has also been supplemented by some foreign capital inflows.
- For instance, Reliance Industries alone attracted global investments aggregating to about $27 billion in its Jio Platforms between April 22 and November 9 in 2020.
- Foreign portfolio investors, too, have pumped $28.65 billion into Indian equity and debt markets so far this fiscal.
- But total foreign capital inflows, net of debt repayments and other outflows, have been only $16.5 billion, as per RBI data for April-September 2020.
- Moreover, unlike in 2007-08, the capital flows coming in now seem to be more courtesy 'push' than 'pull' factors.
- With 10-year US treasury yields currently at 0.91%, investors are being pushed to seek returns in emerging market economies offering relatively higher returns.

- Some of that dollar liquidity has been flowing into India, especially since November.
- In all, it makes for an extraordinary situation of record forex reserves build-up when the economy is experiencing negative growth for the first time in 41 years.

7.2 India's Accumulation of Gold Reserves

What is the issue?

- The RBI has revised its stance towards accumulation of gold reserves in the recent years.
- In this context, here is a look at the gold reserves trend and the rationale for the changes.

What is the current gold reserves status?

- The RBI has not made any move to increase its gold reserves for many years after its purchase of gold from the IMF in 2009.
- But India's gold reserves have been increasing at a steady pace over the last 3 years.
- These purchases have added 137 tonnes to the gold reserves between December 2017 and March 2021.
- The share of gold in India's foreign exchange reserves has increased to 7% currently, from 5% in March 2017.
- The resolve to buy gold is continuing in 2021, with purchases in the first quarter already amounting to 18.7 tonnes.
- The RBI currently holds 695.3 tonnes of gold, ranking tenth globally in gold holding.
- The quantity of holding is less than that of the US, Germany, France and Switzerland.
- However, it is far higher than other emerging economies, with the exception of China

What is the larger trend?

- India is not the only country purchasing gold.
- A few other emerging economies are also following a similar strategy.
- Countries such as Turkey, Russia and Kazakhstan have also been avid buyers of gold over the last 5 years.
- The main reason appears to be the need to reduce the risks emanating from excessive US dollar exposure.
- It is driven by a desire to reduce the dominance of the US over the global economy.
- One way to do so is to reduce the usage of US dollars in their external transactions as well as in their reserves.

What is India's rationale?

- India's desire to add gold reserves seems to be driven mainly by the fear of depreciation in dollar value causing capital loss.
- India's forex reserves have been on an upward trajectory for most part over the last three decades.
- This was because the RBI used the foreign portfolio and direct investment inflows to build its reserves.
- More than one-third of these reserves are held as US treasury securities
- In this context, the beginning of the RBI's recent gold purchases in early 2018 coincides with two events.
    1. the US dollar fell sharply in 2017 as the trade war with China and crash in commodity prices led to selling in dollar assets
    2. yields on US treasury bonds spiked sharply between September 2017 and March 2018
- These two happenings, taken together, would have resulted in a sharp loss in the value of US treasury securities held in foreign exchange reserves.
- Gold prices have also been in a strong up-trend since September 2018, gaining almost 48% since then.
- All these would have encouraged the RBI's resolve further.

What are the downsides to holding gold?

- There are limitations to the gold reserves that India can hold.

- One, gold prices are volatile and can result in sharp capital loss.
- E.g. gold prices crashed around 30% in 2013.A country that held over 50% of its reserves as gold would have seen its reserve deplete by 15% that year.
- One of the objectives behind building forex reserves is to create a buffer to help tide over external account crisis or to support the currency in times of extreme stress.
- So, exposing a large part of reserves to sharp swings in value is not recommended.
- Secondly, gold's property as a safe haven has been questioned quite often in recent past.
- It does provide a hedge in periods of extreme stress that last for short durations, as was seen in March 2020.
- However, over longer time-frames, gold is not an effective hedge for the portfolio.
- Another factor is that liquidity in gold is relatively lower when compared to other fixed income securities.
- Also, if central banks begin offloading large quantities of gold in the market, it tends to impact gold price adversely.
- This, in turn, affects the residual holding in the reserves.
- Also, the assets that make up the reserves should be decided based on –
    - the currency-composition of the country's external trade
    - the currency in which it has borrowed overseas
    - the key currency to which its value is linked and so on
- Given these factors, India needs to hold a chunk of its reserves in US dollars.
- Along with this, the RBI will have to decide how much exposure it wants in gold and regulate its purchases accordingly over the next 2 years.

7.3 FDI Hike in the Insurance Sector

Why in news?

Recently, Union cabinet approved a proposal raise the FDI limit from the current 49 % to 74%.

What is India's Insurance penetration?

- Insurance penetration is defined as ratio of premium underwritten in a given year to the Gross Domestic Product (GDP).
- As per the Economic Survey 2020-21, the insurance penetration in India has risen from 2.71 in 2001 to 3.76 in 2019.
- But this figure is far lower than in countries like Malaysia (4.72), Thailand (4.99) and China (4.3), despite India having24 life insurance companies and 34 non-life insurance companies.
- India's life insurance declined from 3.1 in 2013 to 2.82 in 2019 and non-life insurance is 0.94%.
- But the global insurance penetration stands at 3.35% in the life segment and 3.88 in the non-life segment.
- Similarly, the insurance density (the ratio of premium to population) in India rose from $11.5 in 2001 to $78 in 2019.
- But this data is lower than other Asian economies —Malaysia ($536), Thailand ($389) and China ($430).

What are the reasons for this low penetration?

- Low insurance penetration in India is because of the higher expenditure on insurance firms for increasing the coverage.
- Moreover the existing FII holdings in insurance firms is not been fully utilised.
- The average foreign investment in the insurance companies (both life and non-life) remains well below the current limits.
- Thus increasing the FDI limit could lead to a capital infusion in insurance companies and help them to expand their coverage.

What are the outcomes of this FDI increase?

- It is likely that this move will provide greater comfort to foreign investors due to India's favourable demographics and the underinsured market.
- It will benefit smaller players who currently have limited access to long-term committed sources of finance and foster greater competition among the insurance firms.
- This will also bring additional benefits in the form of greater technical know-how, global expertise in creating new products and better underwriting skills which greatly benefits the consumer.

7.4 US Federal Reserve's Stance and India

What is the news about?

US central bank's statement reiterating that it would maintain an 'accommodative stance' until inflation and employment targets had been met boosted Indian markets.

What is the US's quantitative easing about?

- The economy of US was faring poor with jobless rate of 5.2 percent in August due to lockdowns.
- The Fed opted for Quantitative Easing through Open Market Operations for injecting money into the economy.
- It started to buy bonds to keep long-term interest rates low inducing banks to give loans to genuine borrowers to uplift the economy.

Quantitative Easing involves:

1. Central bank purchasing longer-term securities from the open market in order to increase the money supply.
2. Encouraging lending and investment by interest rate cuts.

What did the Federal Reserve say?

- Federal Reserve said that it would continue to maintain an **accommodative stance** of monetary policy until it achieves an inflation moderately above 2%.
- It has decided to keep the target range for the federal funds rate at 0 to 1/4%.
- It also said that if progress in the economy continues, moderation in the pace of asset purchase (tapering bond buying) may be guaranteed soon.

Tapering means gradual slowing down of purchases of securities and bonds. Once the tapering is complete, the Fed may go for reduction in the size of the balance sheet to slowly remove the monetary stimulus.

What does the Fed's decision mean?

- Low interest rates in the US will ensure continued fund flows from foreign portfolio investors (FPIs) into Indian equities
- An end to asset purchases by mid-2022 will strengthen the case for raising rates in 2023.
- Tapering bond buying could see some outflows from Emerging Markets like India but RBI has prepared the economy well enough by accumulating sufficient foreign exchange reserves.

What will be the trend of Indian markets ?

- There is hope that the economy will witness further reopening and faster consumption-driven growth with faster vaccination.
- Improving domestic economic conditions and the reduction of concerns around Evergrande will boost the Indian markets.
- The progress made towards including Indian sovereign bonds in global bond indices is a welcome step.
- The introduction of Fully Accessible Route (FAR) for FPIs investing in G-secs in 2020 is an important move.
- Inclusion of G-Secs in GBI EM and GBI Aggregate indices by early 2022 will result in annual inflows of $18.5 billion over the next decade.
- Also these inflows are likely to be more stable and long-term in nature when compared to the hot money.

- Centre's clarity on taxation of these securities is needed when both the buyer and seller are not Indian citizens and the intermediary is also outside India.
- Other minor bottlenecks such as simplifying the registration process for FPIs wishing to invest in G-secs and providing access to hedging tools to FPIs should speed up.

8. GENERAL ECONOMY

8.1 All about Fuel Pricing

What is the issue?

- Petrol and diesel prices hit a two-year high in mid-December 2020. Petrol is well above Rs. 80 a litre while diesel is getting there.
- The fact that crude oil - the fountainhead of these fuels - is still below 2018 levels highlights the role of petrol and diesel pricing policies of the government.

What is the fuel pricing mechanism?

- The price of petrol and diesel in India is not determined by the actual costs incurred by PSU refiners.
    - These include crude oil sourcing, refining and marketing costs incurred by Indian Oil, HPCL and BPCL.
- Rather, a formula named the trade parity price (TPP) is used to price these products.
- It assumes that 80% of petrol and diesel is imported into India and 20% is exported.
- So, petrol and diesel prices in India are determined based on prices of these fuels in the international market and not on the basis of crude oil prices.
- The international petrol and diesel prices generally move in line with crude oil prices.
- But it need not always be the case, given that demand and supply dynamics could be different.
- The TPP in dollars is converted to rupees. Then comes other costs and margins of the oil companies, dealer commission and taxes.
- From mid-June 2017, the pricing of petrol and diesel is done through a 'daily pricing' mechanism, based on a 15-day rolling average international rate.
    - So, time lag has an effect too.
- Further, the weakening of the rupee against the dollar over the years has added to the fuel's cost.

What role do taxes play?

- Petrol and diesel are government's good source of revenue.
- During the crude crash earlier in 2020, a cash-strapped Centre raised excise duty on petrol and diesel by Rs. 13-16 a litre.
- Many States too increased their sales tax/VAT.
- But when oil prices started rising, the taxes were not rolled back.
- So fuel prices increased, and customers bore the brunt.
- Notably, taxes now account for about 60% of the fuels' price.
- Besides pricing mechanism and taxes, there are unexplained pauses to price changes, leading to opacity in pricing.
    - E.g. For more than 80 days between March and June 2020, the fuels' prices were frozen when they should have actually fallen.

What are the concerns?

- India imports most of its oil needs but is more than self-sufficient in petrol and diesel production.

- So, the trade parity pricing mechanism has often been criticised, especially since petrol and diesel are 'decontrolled' fuels.
- The complaints include allegations of cartelisation with the three PSU oil companies charging nearly the same price, despite different cost structures and efficiencies.
    - Cartelisation means a group of industry participants coming together to fix pricing of products and services. This may work against the interest of consumers.
- Transparent pricing, based on market principles, will likely help consumers more.

What is the significance?

- Higher petrol and diesel prices don't just mean higher personal transport costs.
- They could also cause a price spike in a host of goods and services, given that these fuels play a big part in running the economy.

8.2 Fuel Prices

Why in news?

Recently, the retail prices of automobile fuels have reached record highs across the country.

Why are consumers in India paying more for petrol and diesel?

- In theory, retail petrol and diesel prices are linked to global crude oil prices i.e. that if crude prices fall, retails prices should come down.
- But this does not happen in practice, largely because oil price decontrol is a one-way street in India.
- So, when global prices go up, the resultant increase is passed on to the consumer but when the reverse happens government slaps fresh taxes and levies.
- This ensures the state gets extra revenues but the consumer, who should have ideally benefited, is forced to spend more.

Why are crude oil prices rising now?

- In April 2020 after the pandemic struck, prices collapsed as the demand fell down.
- But when economies relaxed travel restrictions and factory output picked up, global demand got improved and prices started recovering.
- Brent crude, which was trading at about $40 per barrel between June and October, started rising in November and has gone past the $60 per barrel mark after the rollout of Covid-19 vaccines.
- The controlled production of crude by OPEC Nations amid rising demand has been another key factor in boosting oil prices.

What is the impact of taxes on retail prices of auto fuels?

- Currently, state and central taxes amount to around 180% of the base price of petrol and 141 % of the base price of diesel in Delhi.
- Central government hiked its excise duty on petrol & diesel to boost its revenues as economic activity fell during pandemic.
- A number of states have also hiked sales tax on petrol and diesel to shore up their revenues.
- Now Industrial analysts projected cuts in central excise duty as prices hit record levels but government is not considering any proposal to cut the rates.
- Tax on fuels as a percentage of pump prices is around 65 % of the retail price in Germany and Italy, 62 % in U.K., 45 % in Japan and around 20 % in U.S.
- Besides, oil marketing companies halted daily revisions of petrol and diesel prices for 82 days starting from March 16, 2020.
- They explained that lowering prices in line with international prices will led to negative margins for oil marketing companies.

8.3 Rising Oil Prices

Why in news?

Crude oil prices have hit a two-year high with Brent crude rising above the $71 per barrel mark on 2nd June 2021.

Why are crude oil prices rising?

- In 2020, crude oil prices had reached a low of under $19 per barrel.
- So, key oil-producing countries made supply cuts to balance the prices.
- The Organisation of Petroleum Exporting Countries (OPEC) extended this supply cuts through the first 5 months of 2021.
- Saudi Arabia notably made an additional voluntary production cut of 1 million barrels per day between February and April 2021.
- There were also hopes of improving demand due to economic recoveries across geographies.
- With these, crude oil prices have been rising steadily since the beginning of 2021.
- In 2021 start, Brent Crude was trading at about $52 per barrel.

How will oil prices be in the coming days?

- Increased production and supply could lower the prices in the market.
- Saudi Arabia has started to reverse the voluntary supply cuts.
- Also, OPEC+ has announced that they would adhere to plans entailing a gradual increase in crude oil production.
- However, the gradual withdrawal of supply cuts is unlikely to have any significant impact on prices.
- This is because demand for petroleum products increases, spurred by increasing economic activity.
- Another expectation is the oil production in Iran, with hopeful removal of international sanctions.
- However, any increase in crude oil production from Iran would happen only gradually.
- And it may not destabilise crude oil prices.

How does high crude oil price impact India?

- Rising crude oil prices have contributed to petrol and diesel prices rising to record high levels across the country.
- But oil marketing companies note that even current record-high prices are lower than what refiners should be charging in line with international prices.
- [The prices of petrol and diesel are benchmarked to a 15-day rolling average of the international prices of the petroleum products.]
- Also, prices are set to rise further unless there is a cut on levies on autofuels or a fall in crude oil prices.
- **Tax** - The central government had in 2020 hiked central excise duties on petrol by Rs 13 per litre and those on diesel by Rs 16 per litre.
- This was done to shore up revenues as economic activity fell due to the pandemic.
- Notably, state and central taxes account for about 58% of the pump price of petrol and 52% of that of diesel in Delhi presently (June 2021.)

8.4 One-Person Company

Why in news?

In the Budget speech, Finance Minister announced measures to ease norms for setting up one-person companies.

How many OPCs does India have?

- According to data by Monthly Information Bulletin on Corporate Sector, there are 34,235 OPCs out of a total number of about 1.3 million active companies in India, as of 2020.

- The number of OPCs was 2,238 as of 2015 & more than half of the OPCs are in business services.

How does single-person Company and sole proprietorship differ?

- In single-person Company, the person and the company are considered separate legal entities whereas in sole proprietorship, the owner and the business are considered the same.
- This has an important implication when it comes to the liability of the individual member or owner.
- In a one-person company, the sole owner's liability is limited to that person's investment but in sole proprietorship set-up, the owner has unlimited liability.

What are the changes announced in the budget for these companies?

- The 2014 rule states that OPCs would cease to have that status if its paid-up share capital exceeds Rs 50 lakh or its average turnover for the preceding three years exceeds Rs 2 crore.
- This condition was lifted in this budget.
- Earlier only an Indian citizen and an Indian resident could start a single-person company.
- Now it is proposed that residency limit for an Indian citizen to set up an OPC will be reduced from 182 days to 120 days & NRIs are now allowed to incorporate OPCs in India.
- These changes come along with the proposal to increase the threshold of capital base from Rs 50 lakh to Rs 2 crore & turnover from Rs 2 crore to Rs 20 crore for small companies.
- This means that these companies can have easy compliance requirements for longer time & will address the existing criticism that erstwhile rules governing OPCs are restrictive in nature.

One-Person Company

- It is a company that is formed by just one person as a shareholder in contrast to private companies which require minimum of two members to get going.
- This is helpful to the person wants to get into business through his sole proprietorship mode but they are considered as private companies only.

8.5 Independent Directors

Why in news?

Recently, SEBI made stringent rules for appointment and removal of independent directors to reinforce their independence.

Who is an Independent director?

- An Independent director (ID) is a non-executive director who does not have any kind of relationship, material or financial, with the company.
- They ensure the independence of decisions taken in matters related with the board.

What are the existing rules?

- In 2018, SEBI made sweeping changes in its regulations thereby enlarging the role, responsibilities and eligibility criteria for IDs.
- In 2019, the Ministry of Corporate Affairs prescribed compulsory registration and written exam requirements for IDs.
- Currently IDs are recommended for appointment by the Nomination and Remuneration Committee (NRC) of the Board.
- This will be later ratified through an ordinary resolution passed by the board.

What is the new rule?

- Now SEBI recommends to replace the present rules with a dual approval process.
- It suggests that NRC's recommendation should be approved by a majority of a company's minority shareholders in addition to the ordinary resolution by the board.
- Removal of IDs should also go through the same process.
- To align ID interests with shareholders, it suggests the grant of long-vesting Employee Stock Options (ESOPs).

What are the flaws with new rules?

- Veto Powers for the minority shareholders will prevent the promoters from appointing their favourite IDs.
- But the issue is that retail shareholders are mostly concerned about corporate voting exercises and institutions will hesitate to vote against incumbent managements.
- Hence for well-run companies backed by promoters without ill-intent, this new process will only raise the compliance burden.
- Moreover too many non-executive directors in the board can affect the promoters.
- It is also unfair to expect IDs to view everything from a company's related party deals to mergers and takeovers.

What can be done now?

- To encourage only diligent candidates to apply for IDs, their responsibilities need to be narrowed down and their role needs to be matched to wide-ranging responsibilities of the company.
- The statutory obligations must be restrict IDs to check governance infringement.
- Their participation in strategic decisions should be left to their discretion based on their sector expertise and qualifications.
- Regulators can consider prescribing a slab-wise fee structure for IDs based on company size and complexity.
- They can also devise ways to expand the limited pool of managers who are willing to apply for ID positions.

8.6 Need for Arbitration Body for Financial Disputes

What is the issue?

The rising number of financial disputes and their changing nature highlights the need for an arbitration body for financial disputes in India.

What is litigation and arbitration?

- **Litigation** is a process followed in the courts which are under the administration of the state to resolve disputes between parties.
- In **arbitration**, the parties can consult an arbitration tribunal on their own.
- In this, hearing is done in a private setting and it provides some amount of control to the parties.
    - To note, while arbitration is typically a binding process, **mediation** isa non-binding process.
- The process of litigation is generally expensive than arbitration.
- Arbitration does not get stuck in formal procedures to be followed and therefore is able to avoid delays.

What is the practice so far?

- Financial institutions and banks have **traditionally opted for litigation** instead of arbitration for dispute resolution.
- Litigation, traditionally, offered a more potent forum for recovery of money and resolving financial disputes.
- This is because the judges are vested with stronger powers than an arbitrator is.
- Litigation, as opposed to arbitration, allows judges to exercise multiple powers vested in them.
    - These include interim measures, summary judgments, warrants for non-appearance, etc.
- These options are not available in arbitration.
- In addition, the public nature of disputes in courts and media attention allows the banks to create pressure on the defaulters.

What is the changing trend?

- The traditional view of litigating in financial disputes changed following the 2008-09 financial crisis.
- This is due to the highly complex nature of financial transactions and a need for confidentiality.

- The financial institutes felt a need for adjudicators who possess a deep knowledge of finance and an understanding of complex transactions.
- In addition to these, the institutions opted for a private forum for adjudications, to keep things confidential.
- This is because financial disputes of large quantum often lead to public distress, resulting in negative variations in listed stocks.
- So, banks and financial institutions are **increasingly opting for arbitration** instead of litigation.
- Another reason is that it is easier to enforce an arbitral award as opposed to a court judgment which can be appealed multiple times.
- Given this change, many arbitral institutions have created panels of arbitrators specialising in banking and finance.
- The arbitral institutions have themselves altered their rules to accommodate the peculiar needs of financial disputes.

8.7 Quality Gigs, a Solution to Urban Unemployment

What is the issue?

With no urban equivalent to the National Rural Employment Guarantee Scheme (NREGA) as yet, there must be a focus on supporting new forms of employment here.

What is the unemployment scenario?

- The discourse on post lockdown economic recovery has shifted the focus away from the employment question.
- But more recent data from the Centre for Monitoring Indian Economy point to a gradual slowdown in employment recovery from July 2020.
- The latest numbers point to a sharp rise in the national unemployment rate from 6.51% in November to 9.06% in December 2020.

What role has NREGA played?

- With labour force moving back to rural India, employment support came in the form of an increased outlay for the NREGA.
- It witnessed a 243% increase in person workdays.
- This led to the Rural Development Ministry spending nearly 90% of its increased Rs. 86,400 crore allocation by the month of November 2020.
- However, it is still being unable to fulfil demands for nearly 13% of the 75 million households that demanded work.

What is the condition in urban areas?

- In several Indian cities, businesses are shuttered post the lockdown.
- Millions of workers thus have to either leave or take up new forms of work.
- Some have found the burgeoning **gig economy** to be their only employment source.

What is the status of gig economy?

- In this regard, Fairwork Foundation's annual review of platform labour gains prominence.
- The report evaluates the well-being of gig workers on 11 digital platforms.
- It evaluated them on five metrics of Fair Pay, Fair Conditions, Fair Contracts, Fair Management and Fair Representation.
- In its findings however, only two firms (Urban Company and Flipkart) scored greater than five (out of a maximum of 10) while seven scored only 2 or less.
- Most concerning perhaps, is the fact that the bottom of the rankings are rounded off by India's four largest platform giants, namely, Uber, Ola, Swiggy and Zomato.

What should the government priorities be?

- No urban equivalent to the NREGA is on the horizon.
- So there must be an increased impetus on evaluating, regulating and supporting new forms of employment.
- **Evaluation -** As of now, there exists no authoritative estimate on the total number of gig workers in India.
- Current understanding of gig economy remains constrained to the limited disclosures made by the platforms themselves.
- Furthermore, very few independent studies are evaluating the scale and impact of these platforms.
- So, most regulators continue to remain in the dark on basic questions surrounding platform labour.
- The centralised nature of the platforms and the larger platform labour market only necessitates collating of this data by the Labour Ministry.
- **Regulation -** Some workers use gig economy platforms as a "side hustle."
- For others, it continues to serve as a primary source of employment.
- The varied nature of gig work thus makes regulation highly sensitive.
- This dynamic is further complicated by the risk of a one-size-fits-all regulatory strategy.
- This might unintentionally hurt the similar, yet distinct, market for highly skilled (and highly paid) freelancers.

What is a possible way out?

- A more viable strategy for regulation could involve conditional government **partnerships** with platforms under some of its flagship schemes.
- E.g. the successful pilot of Swiggy's Street Food Vendors programme under the PM SVANidhi scheme
- While onboarding street food vendors onto the platform, Swiggy has also looked to ensure that each vendor is registered and certified by the FSSAI.
- The simultaneous creation of jobs, alongside the voluntary adoption of quality standards is an example of a mutually beneficial partnership.
- Similar collaborations on urban employment with labour platforms complying with disclosure norms and worker compensation standards to access government support would serve the purpose.
- Current proposals for an Urban Employment Guarantee peg daily worker wages at approximately Rs. 300, at a cost of Rs. 1-lakh crore to the exchequer.
- Collaborating with platforms to employ workers would bring down costs significantly for both the state and their partners.
- More importantly, it would create an environment where firms cooperate with the state, as opposed to adopting an antagonistic position.

8.8 Revamping Production-Linked incentive scheme

What is the issue?

Production-Linked incentive scheme has to be revised to secure digital networks & to have supply chain resilience in electronics sector.

What is production-linked incentive (PLI) scheme?

- It was launched with the aim of increasing India's self-reliance in the manufacturing mobile phones & specific electronic components.
- This was later extended to medical devices, computer hardware, telecom & network products etc.
- It offers incentive of 4-6% on a company's incremental sales for a period of 5 years & India-registered Company can apply if it meets certain criteria on additional annual investment & sales.
- For high-end mobile phones, incremental investment in the 1st year must be Rs 250 crore with incremental sales of Rs 4,000 crore.

What is the core objective of the scheme?

- It aims to attract large investments from global Original equipment manufacturers & make Indian manufacturers globally competitive by creating economies of scale.
- In the mid-2000s, steps were undertaken to attract FDI by signing FTA's with ASEAN and others.
- It also aims to establish GVC engagement for Indian electronics firms by creating backward linkages with the domestic MSME suppliers.

What was the concern about FDI-led integration?

- The Phased Manufacturing Programme of the scheme has led to a significant increase in local assembly & exports of smart phones but import of mobile parts and components has also increased.
- Though the company's revenue from the share of exports was 20% in 2018-19,its import was as high as 85% which is dominated by mobile parts and components.
- Since 2015-16 imports of mobile phone parts & components topped in the total electronics imports.

How was the performance of Global value chain (GVC) integration?

- A recent study of assessing GVC participation of Samsung India established the fact that domestic sub-assemblies did not increase domestic value addition.
- More than 80% of the value of major imports was purchased from the South Korean parent company and Samsung Group's various subsidiaries abroad and in India.
- Even higher value-added service like IT consultancy was also purchased from companies operating in India and abroad.
- In 2018-19, it has spent only 0.05 % of its turnover on local R&D & its net foreign exchange was Rs 431.2 billion.
- It is not just Samsung but other Indian subcontractors also carried out heavily import-dependent operations.

What can we infer from this?

- The objective of creating local manufacturing ecosystem did not succeed & there was a huge foreign exchange leakage.
- The net forex outflow of Samsung alone accounted for about 31 % of India's total electronics exports in 2018-19.
- FTAs incentivised imports have led to import dependence by the foreign invested and domestic companies.
- Lack of focus on R&D by the private industry has led to low domestic value addition.
- Despite India having strong capabilities in designing integrated circuit (IC), design takes place in MNC R&D centres abroad & getting patent there.
- Hence large share of the value addition from an increase in product sales accrue to the patent owners along the entire value chain leading to forex leakages.

What can be done now?

- The ownership & control of intellectual property of designs & products based on them should go to Indian companies headquartered in India.
- Hence PLI scheme must be revamped to link the incentives directly to a company's investments of 5-6% of annual turnover on R&D.
- Incentives can be tied to the number of patents filed in India based on research in India.
- India must re-visit the role played by our public sector telecom research laboratories- Centre for the Development of Telematics, Centre for Development of Advanced Computing.
- Both the laboratories should validate & acquire indigenously designed & manufactured products with embedded software/new technologies from start-ups and other SMEs.
- This can prevent them from selling their technologies to foreign investors & retain its ownership in India.

8.9 SC upholds IBC's Section 32A

Why in news?

In its judgment, the Supreme Court (SC) upheld the validity of Section 32 A of Insolvency and Bankruptcy Code (IBC).

What did the judgment specify?

- Section 32A of the IBC offers protection to successful bidders and the assets of a corporate debtor.
- The court said that the successful bidders for a corporate debtor under the IBC would be immune from any investigations being conducted.
    - This applies to investigations either by any investigating agencies such as the Enforcement Directorate (ED) or other statutory bodies such as the SEBI.
- SC also said it was important for the IBC to attract bidders who would offer reasonable and fair value for the corporate debtor.
- This is to ensure the timely completion of corporate insolvency resolution process (CIRP).
- Such bidders, however, must also be granted protection from any misdeeds of the past since they had nothing to do with it.
- Such protection must also extend to the assets of a corporate debtor.
- The court has, however, said that the immunity would be applicable only if there is an approved resolution plan, and a change in the management control of the corporate debtor.
- The new management cannot be the disguised version of the old management. It cannot even be the related party of the corporate debtor.

How does this help?

- The protection forms a crucial attraction for potential bidders.
- It helps them in assessing and placing a fair bid for the company.
- This, in turn, will help banks clean up their books of bad loans.
- The extinguishment of the criminal liability of the corporate debtor is apparently important to the new management.
- This will help make a clean break with the past and start on a clean slate.

Why is the SC upholding Section 32A important?

- Since the IBC came into being in 2016, the implementation of resolution plan of several big ticket cases has been delayed.
- This was because of various challenges mounted by its own agencies and regulators.
- With the Supreme Court upholding the validity of Section 32 A, the cases delayed are expected to be completed soon.
- This is also expected to give confidence to other bidders to proceed with confidence while bidding on such disputed companies and their assets.

8.10 Widening Inequality

Why in news?

As per recent Oxfam report, Indian billionaires wealth increased by 35% during the lockdown.

What does the report say?

- Inequality was alarmingly high and it destabilises social and political order in the world even before the pandemic & economists say it is set to further aggravate.
- It says that 1,000 richest people worldwide recovered their losses from the pandemic within nine months.
- But worlds poorest might take a decade to limp back to their pre-pandemic standing.
- The additional wealth acquired by India's 100 billionaires since March when the lockdown was imposed is enough to give every one of the 138 million poorest a cheque of Rs 94,045 each.
- The increase in wealth alone could keep 40 crore informal workers out of poverty for at least five months.

What are the other details in the report?

- The economic recovery is uneven among countries and within countries & economic inequality is rising sharply in all countries.
- An unskilled worker in India would take three years to earn what the country's richest person earned in one second last year.
- The worsening inequality in income and opportunities impacts some sections disproportionately due to discrimination based on gender, caste and people worstly affected by the disease.
- It also says that wealth of just the top 11 billionaires during the pandemic could easily sustain the MGNREGS or the Health Ministry for the next 10 years.

What are the various forms of inequity highlighted by the report?

- Economists agree that distribution of new wealth between capital and labour has become so one-sided that workers are constantly being pushed to deprivation while the rich are getting richer.
- **Health:** only 6% of the poorest & 20% have access to non-shared sources of improved sanitation compared to 93.4 % of top 20 %.
- 59.6 % of India's population lived in a room or less, which means that protocols to prevent the spread of COVID-19 is not followed.
- Though government took steps to make COVID-19 services affordable by including them under Ayushman Bharat-PMJAY, it covered BPL leaving out the uninsured poor and the middle class.
- **Education:** Till October, 32 crores students were hit by closure of schools, of whom 84 % resided in rural areas and 70 %attended government schools.
- It says that across five States close to 40 % of teachers in government schools feared that the prolonged school closure might lead to a third of the students not returning once schools reopened.
- Dalits, Adivasis and Muslims were likely to see a higher rate of dropout & Girls are most vulnerable as they were at risk of early and forced marriage, violence and early pregnancies.
- **Gender:** Unemployment of women rose by 15% from a pre-lockdown level of 18 %, which could result in a loss of India's GDP of about 8 % or Rs 15 trillion.
- Women who were employed before the lockdown were also 23.5 % points less likely to be re-employed compared to men in the post lockdown phase.

How to address this?

- Inequality came to be seen as a outcome of economic growth & politicians and policy makers accept that rising inequality is inevitable.
- According to its estimate, wealth tax on the nation's 954 richest families could raise the equivalent of 1% of the GDP.
- It recommended reintroducing the wealth tax and imposing a one-time COVID-19 cess of 4% on taxable income of over Rs 10 lakh will help in economic recovery from the lockdown.

8.11 MSME Udyam Registration – Low Rate

What is the issue?

- In June 2020, the MoMSME issued a notification revising the definition of Micro, Small and Medium Enterprises (MSMEs) and introduced a new registration system — the Udyam.
- But the numbers for the new Udyam registration system remains low, and here is why.

What were the changes made?

- With effect from July 1, 2020, the revisions in the MSME definition were three-fold:
  i. the distinction between manufacturing and services sector MMSEs was removed
  ii. an additional criterion of turnover was introduced
  iii. investment thresholds were revised upwards

- The notification also introduced a new procedure for registration in accordance with the revised MSME definition, under the Udyam system.

How is the level of registrations?

- As on March 31, 2021, which was the deadline for registering under the new Udyam system, only 26.4 lakh enterprises have registered.
- This means less than 5% of the total estimated MSMEs (6.33 crore) in the country are Udyam registered now.
- The previous registration system for MSMEs — the UdyogAadhaar Memorandum (UAM) — had more registrations.
    - Introduced in 2015 and operational until June 2020, this system had a little over one crore registrations.
    - This is approximately 16% of the estimated MSMEs.
- Like the UAM system, the Udyam system is also free of cost, paperless and digital.
- An important difference is that under Udyam, once Aadhaar/PAN is provided, all the relevant income tax and GST data can be pulled from the respective government databases, at the backend.
- Moreover, a single registration is enough for multiple activities undertaken by the same enterprise.

What are the benefits under Udyam registration?

- Enterprises who self-certify and attain registration are eligible for certain benefits.
- These range from being eligible for subsidy schemes like the Credit Linked Capital Subsidy Scheme (CLCSS) to registering complaints regarding delayed payments on the MSME SAMADHAAN portal.
- As per the RBI's notification, from August 2020, lenders may demand the Udyam registration for credit purposes.
- The Udyam portal is also integrated with the Government e-Marketplace and the Trade Receivables and Discounting System (TReDS).
- So, these enterprises can participate in government procurement, and have a mechanism for discounting their bills.

Why is the registration rate low then?

- One reason could be the earlier requirement that companies that wanted to register under Udyam had to provide their GSTIN.
- Since many companies have a turnover of less than Rs 40 lakh and hence do not need to be GST compliant, it rendered them ineligible to register.
- Such a requirement was removed by the MoMSME on March 5, 2021.
- However, since the deadline for registration was March 31, 2021, this intervention could have deterred many MSMEs from registering.
- Of the total Udyam registered enterprises, only 2% are with GSTIN.
- Another reason could be the lack of awareness regarding the new registration system itself.
- This is a general observation when examining low off-take of schemes that are rolled out for the sector.
- Low levels of awareness regarding the roll-out of schemes, their eligibility conditions, paperwork requirements and grievance redress mechanisms impact overall off-take of these schemes.
- Another grim but likely explanation could be that a vast number of MSMEs have had to wind down in the pandemic period.
- Despite policy initiatives to give the sector a fillip, lockdowns and disruptions in supply chains have had their own impact.

What will the implication be?

- The fate of close to 6 crore unregistered entities remains uncertain.

- The question remains whether they will be allowed to avail subsidies and other credit facilities without an Udyam registration.
- Priority Sector Lending (PSL) directions have not stated an explicit requirement for a UAM or the Udyam number.
- However, since the RBI has allowed lenders to demand the Udyam registration for credit purposes, it is possible that some may choose to do so.
- Given the already burgeoning credit gap in the sector, lenders placing such requirements for a priority sector could further accentuate the credit gap for MSMEs.

What next?

- While the expectation is that the deadline will be extended, the need to ramp up the execution of such important initiatives cannot be overstated.
- Ten states in the country account for 74% of the total estimated MSMEs.
- In states that make up the predominant share of MSMEs, the MSME-District Institutes and other field offices of the MoMSME must be roped in.
- They must be tasked with educating and creating awareness regarding the Udyam system, on a priority basis.
- Last-mile awareness regarding systems and schemes that can benefit MSMEs will be a necessary step towards bridging the never-ending access gap.

8.12 Rural India - Economy's 'Saviour' in 2020-21

What is the issue?

- 2020-21 saw the Indian economy register its worst-ever contraction since Independence and also the first since 1979-80.
- But rural economy was resilient, supported by various factors. Here is a look at them and the future prospects.

What is different this time?

- There have been four instances of negative GDP growth earlier: 1979-80, 1972-73, 1965-66 and 1957-58.
- All four were drought years.
- These years saw agricultural de-growth surpassing that of overall GDP.
- But in 2020-21, there has been record economic contraction, yet no drought.
- And the farm sector (agriculture, forestry & fishing) actually grew by 3.6%.

What are the key reasons for this?

- **Monsoon** - All-India rainfall during the southwest monsoon season (June-September) for 2019 and 2020 were above-normal.
- The country received 971.8 mm and 961.4 mm monsoon rainfall respectively, above the long period average of 880.6 mm.
- Rainfall in the post-monsoon, winter and pre-monsoon seasons of 2019 and 2020 were also good.
- So, 2019-20 and 2020-21 produced back-to-back bumper harvests.
- **Lockdown** - Agriculture was exempted from the nationwide pandemic-induced lockdown.
- There was also the inherent resilience and adaptability of rural economic actors.
- So, the farm sector was relatively insulated from lockdown-imposed supply-side restrictions.
- [The problems agriculture encountered due to the lockdown had more to do with the demand side.
- This was not from rising prices but from forced consumption reduction.]

How were the demand side problems addressed?

- The demand-side problem was partly addressed through enhanced state crop procurement under MSP scheme.

- There was also the first-instalment direct transfers to farmer accounts under the PM-Kisan scheme.
- Both these added to the liquidity infusion into the agricultural economy.
- Demand situation improvedwith the gradual lifting of lockdown restrictions.
- [The MSP procurement intervention was not possible in non-mainstream produce. E.g. vegetables, fruits, poultry, fish, flowers, spices, etc.
- It also did not help in regions (E.g. maize in Bihar)where the institutional mechanisms for procurement were non-existent.
- E.g. Food Corporation of India, NAFED, Cotton Corporation of India or even cooperative dairies]

What else favoured rural economy?

- There was recovery in global agri-commodity prices;better price realizations worked in farmers' favour.
- 2020-21 was also notable for the record 389.35 crore person-days of employment generated under MGNREGA.
- This was yet another source of liquidity infusion.
- Rural consumption, in turn, provided some cushion to the economy.

Will the rural economy perform the same way in 2021-22?

- **Covid-19 cases** - Rural areas were mostly unaffected by the pandemic's first wave.
- However, in the second wave of COVID-19, there are more cases in rural districts as well.
- So, the impact on agriculture per se would depend on the spread, intensity and duration of the infection.
- **Monsoon** - The India Meteorological Departmenthas forecast a 74% probability of rainfall being "normal", "above-normal" or "excess".
- The good news this time is that there is no El Niño.
- There are also increased chances of a La Niña.
- [It is El Niño's counterpart and is associated with above-normal rains and lower temperatures in India for the autumn and winter months.]
- That augurs well for the next rabi crop too.
- The other element influencing rainfall - Indian Ocean Dipole (IOD) –is currently "neutral."
- But there is a possibility of negative conditions developing during the monsoon months.
- Also, unseasonal summer showers may upset the normal heating pattern.
- These factors might undermine a little the optimism with monsoon rains.
- **Prices** - Global prices of wheat, maize, soyabean, palm oil, sugar, skimmed milk powder or cotton have scaled multi-year highs in the recent period.
- This has helped India's agri-commodity exports in 2020-21 to recover to near their peak 2013-14 levels.
- But export demand alone may not sustain prices.
- Especially, job and income losses, accelerated post the pandemic, have severely dented domestic purchasing power.
- Also, even the benefits reaped by farmers from improved prices in many crops have been significantly eroded by rising input costs.
- Diesel prices alone have gone up by over a third in the last one year.
- Non-urea fertilizers prices have also gone up.

8.13 Draft Rules for E-Commerce Companies

Why in news?

The government has proposed changes to the e-commerce rules under the Consumer Protection Act.

What are the key provisions?

- **Sales** - The draft rules seek to ban "specific flash sales" by e-commerce entities.
- Conventional e-commerce flash sales are not banned.
- However, specific flash sales or back-to-back sales "which limit customer choice, increase prices and prevents a level playing field are not allowed".
- **Liability** - In several cases, when problems arise with goods purchased, e-commerce platforms direct the consumers to the respective sellers.
- The rules have introduced the concept of "fall-back liability."
- With fall-back liability, consumers will be able to reach out to the platform itself to solve the grievance.
- E-commerce firms will be held liable iftheir seller fails to deliver goods or services due to negligent conduct, which causes loss to the customer.
- **Preferential treatment** - The rules propose to restrict e-commerce companies from "manipulating search results or search indexes."
- This will address the long-standing demand from sellers and traders to prevent preferential treatment to certain platforms.
- **Privacy** - Without express and affirmative consent, e-commerce companies cannot make available to any person information pertaining to the consumer.
- No entity shall record consent automatically, including in the form of pre-ticked checkboxes.
- **Domestic goods** - The companies will have to provide domestic alternatives to imported goods.
- This adds to the government's push for made-in-India products.
- **Other rules** - Any online retailer will first have to register itself with the Department of Promotion for Industry and Internal Trade (DPIIT).
- No logistics service provider of a marketplace e-commerce entity shall provide differentiated treatment between sellers of the same category.
- Parties and associated enterprises related to e-commerce companies will not be allowed to be enlisted as sellers on the respective platform.
- This follows from the DPIIT's foreign direct investment policy for e-commerce marketplaces.
- Any entity having 10% or more common ultimate beneficial ownership will be considered an "associated enterprise" of an e-commerce platform.
- The draft amendment also proposes to ask e-commerce firms to mandatorily become a part of the National Consumer Helpline.

What is similar to the IT intermediary rules?

- The IT intermediary ruleswere announced recently for social media companies.
- Similar to this, the Consumer Affairs Ministry has proposed to mandate e-commerce companies to make few appointments.
- These are a grievance officer, a chief compliance officer and a nodal contact person for 24×7 coordination with law enforcement agencies.
- E-commerce companies are also asked to share information with a government agency lawfully authorised for investigative or protective or cyber security activities.
- This is for the purposes of verification of identity or for any legal procedures or in relation with cyber security incidents.
- The information so sought will have to be produced by the e-commerce company within 72 hours of the receipt of an order from the said authority.

8.14 Protection of Intellectual Property Online

Why in news?

Union Minister Ravi Shankar Prasad was locked out of his Twitter account for an hour, allegedly over a notice received for violation of the Digital Millennium Copyright Act (DMCA).

What is the DMCA?

- The Digital Millennium Copyright Act, or DMCA, is a 1998 law passed in the US.
- It is among the world's first laws recognising intellectual property on the internet.
- It was signed into law by the then US President Bill Clinton.
- It oversees the implementation of the two treaties signed and agreed upon by member nations of the World Intellectual Property Organisation (WIPO) in 1996.
- These are the WIPO Copyright Treaty and the WIPO Performances and Phonograms Treaty.

Why did the treaties come into place?

- There was rapid commercialisation of internet in late 1990s.
- This started with static advertisement panels being displayed on the internet.
- With this, it became important for website owners to get the user to spend more time on their webpage.
- For this, fresh content was generated by creators and shared over the Internet.
- The problem started when the content would be copied by unscrupulous websites or users, who did not generate content on their own.
- Further, with expansion, websites from countries other than the one where the content originated also started to copy the unique content generated by the websites.
- To avoid this and bring to task the unauthorised copiers, the members of WIPO agreed to extend the copyright and intellectual property protection to digital content.
- As of date, 193 nations across the world, including India, are members of WIPO which was established in 1967.

What do the treaties mandate?

- Both the treaties require member nations and signatories to provide in their respective jurisdictions the below.
- - Protection to intellectual property that may have been created by citizens of different nations who are also co-signatories to the treaty.
- The said protection must not be any less than the one being given to a domestic copyright holder.
- They also obligate that signatories ensure ways to prevent circumvention of the technical measures used to protect copyrighted work.
- They also provide the necessary international legal protection to digital content.

What happens with violation, and how does DMCA work?

- Content creators of any form who believe that their original content has been copied by user or a website without authorisation can file an application.
- It can be filed citing that their intellectual property had been stolen or violated.
- They can approach the website on which the content has been hosted, or third party service providers like DMCA.com.
- These third party service providers utilise a team of experts to help take down the stolen content for a small fee.
- In the case of social media intermediaries like Facebook, Instagram or Twitter, content creators can directly approach the platform.
- They should have a proof of them being original creators.
- These companies operate in nations which are signatories to the WIPO treaty.

- So, they are obligated to remove the said content if they receive a valid and legal DMCA takedown notice.
- Platforms, however, also give the other users against whom allegations of content cheating have been made, a chance to reply to the notice.
- The platform shall then decide which party is telling the truth, and shall accordingly, either restore the content or keep it hidden.

8.15 India's 1991 Liberalisation Leap & Lessons

What is the issue?

- It is three decades after India embarked upon the path of economic liberalisation in 1991.
- In this context, here is an assessment of the decision and the results of the reforms.

How were the pre-reforms years?

- The private sector was not allowed to invest in a number of sectors thought to be critical for development.
- Key sectors were reserved for the public sector despite its lacklustre performance.
- Where the private sector was allowed, it could invest only after getting an industrial licence.
- That was especially hard to get for "large" industrial houses.
- Over 860 items were reserved exclusively for small-scale producers.
- These included many items that had very high export potential.
- So, imports were more strictly controlled than in almost any other developing country.
- This was because it was felt necessary to conserve scarce foreign exchange.
- Consumer goods simply could not be imported, so domestic producers faced no import competition.
- Producers could import capital goods and intermediates needed for production.
- But this again required an import licence.
- This was given only if the government was satisfied that the import was essential and domestic substitutes were not available.
- Finally, the import of technology was controlled and Foreign Direct Investment (FDI) was discouraged.
- Clearly, it was not a system geared to encourage enterprise or innovation.
- Efforts were made in the 1980s to liberalise the system but these were incremental changes.
- By 1990, it was clear that drastic change was needed.

What have the 1991 reforms achieved?

- The reforms were aimed at unleashing the energies of the private sector to accelerate economic growth.
- This was to be done in a manner that ensured an adequate flow of benefits to the poor.
- The reforms certainly succeeded in this objective.
- The full benefits took time to materialise because a gradualist approach was adopted.
- But the results are dramatic if seen in a longer time frame.
- The GDP growth averaged 7% in the 25 years from 1992 to 2017.
- The preceding ten years had an average of 5% and the preceding 20 years, 4%.
- Importantly, as growth accelerated, poverty declined.

What are the shortcomings though?

- Some of the reforms begun in 1991, especially in the financial sector, are yet to be completed.
- Also, in the health and education sectors, what have been done is much below the potential and need.
- Environmental concerns have not been adequately built into the development strategy.

- India is still at the lower end of the middle-income group of countries.
- Many more reforms are needed to get to the top of the group.
- The need for labour market reforms was recognised.
- But attention was given first to get the industrial, trade and financial sector reforms,and take up labour market reforms later.
- **Employment** - There was a fall in employment in agriculture after 1991.
- But it was accompanied by sufficient growth in total employment in non-agriculture sectors.
- Also, total employment actually increased.
- The disappointing thing was that employment in manufacturing did not increase as rapidly as one would have liked.
- This was because Indian was not able to replicate the East Asian experience of rapid growth in the export of labour-intensive manufactures.
- Also, most of the increase in employment, including in manufacturing, was not regular contractual employment but informal non-contractual employment.

What about import tariffs?

- India progressively lowered import tariffs from an estimated 57.5% in 1992 to 8.9% in 2008.
- But this trend has been reversed over the past few years.
- This appears to be in line with rising protectionism globally.
- But increasing the import tariffs will hamper India's stated ambition to become part of global supply chains.
- Indian industry has legitimate complaints about poor infrastructure, poor logistics and time-consuming trade procedures, which reduce its competitiveness.
- But the solution lies in addressing these problems directly.
- Raising import duties, which will only raise costs in the economy, is not the right solution.
- The government should engage with Indian industry and other experts.
- Moving to an average duty rate of about 7%, gradually narrowing the range of variation across products and eliminating duty reversals would be the right approach.

8.16 SC Ruling on Antitrust Investigations

Why in news?

The Supreme Court has ruled that India's competition regulator (Competition Commission of India) would proceed with antitrust investigations into Amazon and Walmart-owned Flipkart.

What is the CCI investigation for?

- Amazon and Flipkart allegedly had exclusive agreements with smartphone brands for the sale of certain devices on their platforms.
- These platforms had given preferential treatment to certain sellers by giving them higher search rankings and offerings.
- The platforms would incur part of the discount that such sellers would offer during key sales periods.
- The CCI had in 2020 ordered an investigation based on such allegations by trade body Delhi Vyapar Mahasangh.

What is the stance of Flipkart and Amazon?

- Amazon and Flipkart had approached the Karnataka HC to quash the order by the CCI, on the following grounds:
- It was the choice of the manufacturer if they wanted to sell a smartphone exclusively on one platform.

- There were no agreements between them and sellers on record that were shown to likely have a negative impact on competition.
- The CCI did not have enough evidence to pursue the matter.
- It had not formed a prima facie opinion on the potential impact on the competition while passing the orders.

What have the Courts ruled?

- The High Court and Supreme Court have rejected the petitions by Amazon and Flipkart that a probe into the companies be quashed.
- The high court concluded that orders by the CCI initiating an investigation were administrative directions.
- So, the CCI was not bound to enter an adjudicatory process or form an opinion before ordering an investigation.

What is the significance?

- Amazon and Flipkart are leading players in e-retail market in India.
- The increasing dependence of sellers on online platforms meant that certain platforms were becoming essential facilities and had to treat sellers in an unbiased manner.
- But "opacity in platform rankings" had become a cause for competition concern in the recent period.

8.17 Economy Since 1991

What is the issue?

With three decades from the 1991 economic reforms, here is a reflection into the performance of the economy over the years and the course corrections needed.

What is the 1991 reforms all about?

- **Objectives**
  1. Address the balance of payments (BoP) crisis
  2. Reform, restructure and modernise the economy, with fundamental changes in the approach and conduct of economic policy.
  3. Improve the productivity and efficiency of the system by creating a more competitive environment.
- So the reforms brought three important changes:
  1. Dismantling the vast network of licences, controls and permits that dominated the economic system (Liberalisation)
  2. Redesigning the role of the state and allowing the private sector a larger space to operate within (Privatisation)
  3. Abandoning the inward-looking foreign trade policy and getting integrated with the world economy and trade (Globalisation)
- The last was particularly important as normally the opposite of it is done when faced with a BoP crisis. But instead, the barriers to entry and growth were removed.

How has the economy performed post-1991 liberalisation?

- **Growth Rate -** GDP at factor costgrew annually by
  1. 6.20% between 1992-93 and 2000-01
  2. 7.69% between 2001-02 and 2010-11
  3. 6.51% between 2011-12 and 2019-20
- The best performance was between 2005-06 and 2010-11 when the GDP grew by 8.7%.
- This is the highest growth experienced by India over a sustained period of 5 to 6 years (despite the 2008-09 global economic crisis).
- Notably, the recent decline in growth rate started even before the advent of COVID-19.

- **Current Account Deficit (CAD)**
- Simply, CAD is the shortfall between the money flowing in on exports, and the money flowing out on imports.
- A rising CAD shows that the country is becoming **uncompetitive** and the investment climate is getting weak.
- The key changes made in this regard in 1991 were:
    1. opening up of the external sector, which included liberal trade policy
    2. market determined exchange rate
    3. liberal flow of external resources
- Post-reforms period witnessed
    1. a small Current Account Deficit in most of the years
    2. a small surplus in three years
    3. exceptions in 2011-12 and 2012-13 as CAD exceeded 4%, but was taken care of quickly
- Foreign exchange reserves showed a substantial increase and has touched $621 billion (August 2021).
- But India still has a high merchandise trade deficit, which is offset to a large extent by the surplus in services.
- **Poverty ratio** - The post-reform period up to 2011-12 saw a significant reduction in poverty ratio.
- The factors were faster growth supplemented by appropriate poverty reduction programmes [Rural Employment Guarantee Scheme, Extended Food Security Scheme].

1. As estimated by the erstwhile Planning Commission using the Tendulkar expert group methodology, the overall poverty ratio –
    1. came down from 45.3% in 1993-94 to 37.2% in 2004-05
    2. further down to 21.9% in 2011-12

- But with a decline in growth rate since 2011-12 and a negative growth in 2020-21, the poverty rate may have increased.

What is the priority now?

- The progressive decline of growth rate since 2011 is largely driven by the decline in investment rate (5 percentage points since 2010-11).
- While growth is driven by investment and reforms do provide a natural climate for investment, the real growth **requires more than reforms**.
- It should take into account the influence of the non-economic factors such as social cohesion and equity.

What should the approach from now on be?

- Focussing on reform agenda which is incremental in character, supplemented by a careful nurturing of the investment climate.
- Identifying the sectors which need reforms for a competitive environment and improved performance efficiency.
- A relook at the financial system, power sector and governance, with Centre and States being joint partners in this.
- Increased focus on social sectors such as health and education in terms of government performance.
- Emphasis on quality beyond the quantitative expansion in service delivery.
- Overall, same economic approach and direction as in the past three decades, with added equity considerations.
- Growth and equity are interdependent i.e., only in an environment of high growth, can equity be pushed aggressively.

8.18 PLFS Data

What is the issue?

- NSO Periodic Labour Force Survey (PLFS) data for 2019-2020 was released recently.
- While the increase in Workforce Participation Rate (WPR) is taken for good, the underlying reasons suggest at a deeper crisis in the economy.

What are the PLFS and WPR?

- PLFS is India's first computer-based survey launched by the NSSO in 2017.
- The two major objectives:

1. To estimate the key employment and unemployment indicators for the urban areas only in the 'Current Weekly Status' (CWS) quarterly.
2. To estimate the employment and unemployment indicators in both 'Usual Status' (ps+ss) and CWS in both rural and urban areas annually.

What is the WPR data in the recent survey?

Overall

- Usual status (ps+ss) – Increase from 35.3% to 38.2% from 2018-19 to 2019-20, an 8.2% growth.
- Rural areas - Increase from 35.8% to 39.2%, a 9.5% growth
- Urban areas - Increase from 34.1% to 35.9%, a mere 5.3% growth

Gender-wise

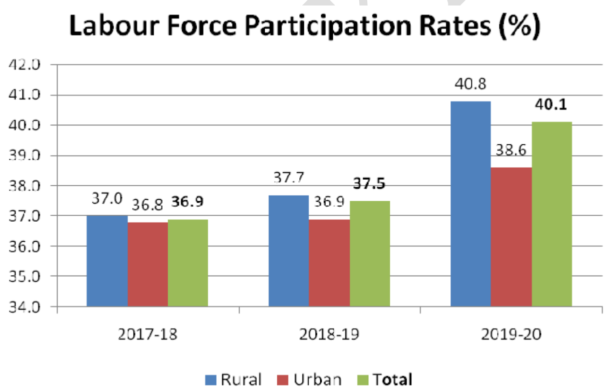
- Rural females – An increase of **26%**(19 to 24% share).
- Rural males - An increase of **3.3%**(52.1 - 53.8% share).
- Urban females - Increase from 14.8 to 16.8% (a **15.8%** growth)
- Urban males - Increase from 52.7 to 54.1% (**2.7%** growth).

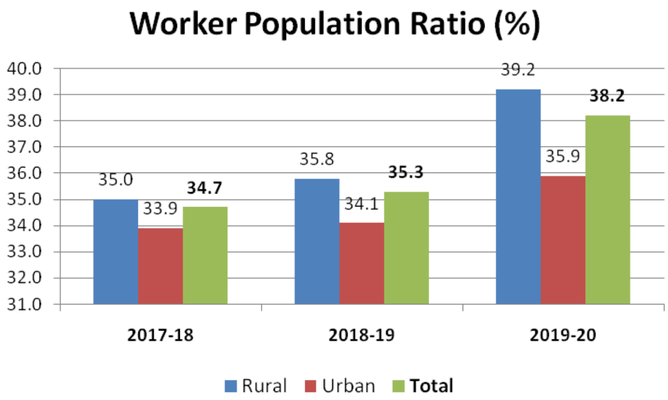
Joblessness is bad enough but underemployment has been worsening as the jobless return to farms

Usual Status - Determined on the basis of the referer
the last 365 days preceding the date of survey.

Current Weekly Status (CWS) - Determined on th
reference period of the last 7 days preceding the date c

WPR - Percentage of total workers to the total populati





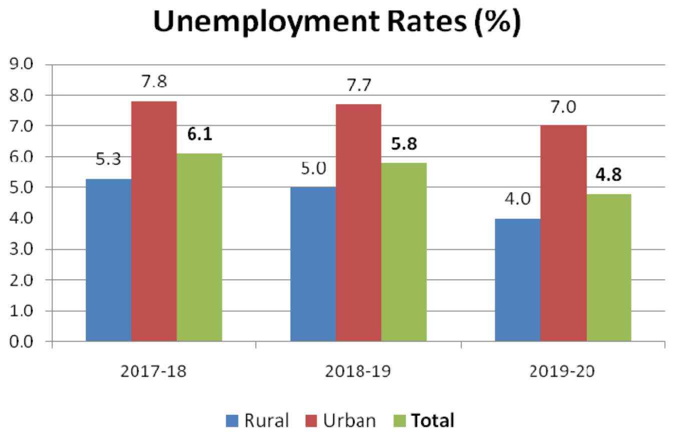
Rural India emerging as the primary location for job creation

Broader trends

- The female WPR has risen significantlyacross social groups:

i. Rural female from the Scheduled Tribe - 33.2%; the highest recorded
ii. Others - 29.4%; SC - 25.4%; OBC- 24.3%

- Urban areas registered a much lower rise in the WPR compared to rural areas.
- The share of self-employed workers has increased from 52.1% in 2018-19 to 53.5% in 2019-20.
- The rural females witnessed an increase in the self-employed category from 59.6% to 63%.



Is the increase in WPR a good sign?

- **Generally, yes.** Because, a higher WPR is generally an indication of improved well-being of the population.
- **But** in a poor region with higher WPR, there may not be necessarily an improved economic status and well-being.
- And now, the 3-month nationwide lockdown in March 2020 coincided with the 4th quarter of PLFS 2019-20.
- It was the time when economic activities stalled intermittently, GDP growth dipped, unemployment and income losses were high.

So, what are the true reasons behind?

- Post pandemic decline in good-quality employment led many to opt for low paid work in rural India.
- The general pattern is a shift of workers away from low-productivity sectors such as agriculture.
- India too witnessed a decline in agriculture's share of overall employment since the 1970s that continued until 2017-18.
- But 2019-20 saw a sharp 32 million rise in employment in agriculture; (1st time in 5 decades)

*Many were forced to seek **distress employment** resulting in a 43-million rise in total employment numbers in 2019-20 from the year earlier. Agriculture absorbed almost 3/4th of this increase in workers.*

- This **reverses the structural transformation of the economy** underway since 2004-05.

What are the other reasons and the concerns?

- **Decline -** Majority of workers turned to self-employment as regular employment declined.
- **Unpaid Labour -** Increase in the self-employed rural females is principally due to an increase in the share of helpers in the household enterprises.
- Counting them as 'employed' is deceptive, as it is often unpaid labour.
- **Loan Account -** Overall increase in loan account under the female share of MUDRA Scheme in all 3 categories (Shishu, Kishore and Tarun) in 2019-20.
- A mere increase in the loan account especially in the Shishu category does not necessarily lead to employment creation and sustainable income generation. Counting all as 'employed' is again flawed.
- **Wages** remained almost constant in 2019-20 over 2018-19 for all - Regular/salaried, Self-employed, Casual workers.

What should be done?

- Taking the increase in the WPR for good might be a misinterpretation.

- The PLFS estimates are instead an early warning of a structural crisis.
- The first three quarters also suggest that a structural retrogression in the economy was underway before the pandemic.
- Only creation of productive and remunerative jobs would course correct this structural change.
- Also, a better indicator for the extent of joblessness in the economy would be the number of hours worked.

8.19 National Monetisation Pipeline

Why in news?

The Union government has announced its plans to "monetize" about Rs 6 trillion worth of assets held by it, and public sector units (PSUs), under the National Monetisation Pipeline (NMP).

What is monetisation?

- When a government transfers its revenue rights to private parties in return for upfront money, a revenue share, and commitment of investments in the assets, it is called a monetisation transaction.
- It is done for a specified transaction period to raise funds.
- Private players will have to -
    1. calculate what they can earn from it in various ways in those years
    2. discount that cash flow to its 'present value' (PV)
    3. deduct from PV their profit margin
    4. pay the balance amount as upfront rental to the government i.e., pay for operation and management rights
- Unlike the disinvestment, there will **not be a change of ownership** i.e., the assets or the land therein will not be sold.
- E.g Real estate investment trusts (REITs) and infrastructure investment trusts (InvITs) are the key structures used to monetise assets in the roads and power sectors.

What are the other models?

- Other monetisation models on Public Private Partnership (PPP) basis include
    1. Operate Maintain Transfer (OMT),
    2. Toll Operate Transfer (TOT), and
    3. Operations, Maintenance & Development (OMD).
- OMT and TOT have been used in highways sector while OMD is being deployed in case of airports.
- In sectors like mining, Centre may also look for auction and Mine Development Operator routes.
- The choice of instrument will be determined based on
    1. nature of asset,
    2. timing of transactions (including market considerations),
    3. target investor profile & and
    4. the level of operational/investment control envisaged to be retained by the asset owner etc.

What is the National Monetisation Pipeline?

- It aims to unlock value in brownfield projects by engaging the private sector.
- It aims to transfer revenue rights to the private players (not ownership in the projects).
- The private players operating the assets are also expected to modernize them.
- The funds generated (around Rs. 5.96-lakh crore) will be used for infrastructure creation across the country.
- This, in turn, could help fund the National Infrastructure Pipeline with new projects worth Rs. 100-lakh crore.

- Developed by NITI Aayog, in consultation with infrastructure line ministries.

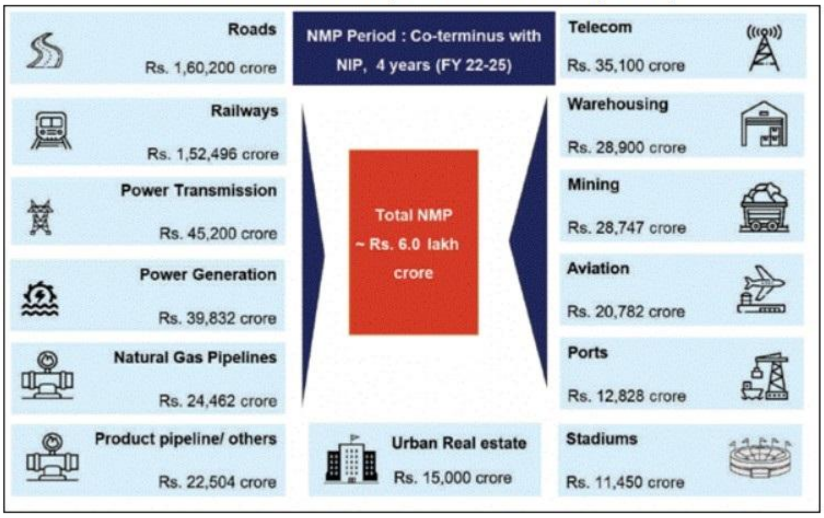
Greenfield investment - A company will build its own, brand-new facilities from the scratch

Brownfield investment - A company purchases or leases an existing facility.

What are the key assets identified?

- Road sector (maximum) - Rs 1.6 lakh crore worth national highways
- Railways sector - About 400 stations, 150 trains, and some tracks and woodshed
- Power sector - Rs 67,000 crore worth transmission lines from Power Grid and Rs 32,000 crore worth Hydro, Solar, and Wind projects from NHPC, NTPC, and Neyveli Lignite

Sector-wise Monetisation Pipeline over FY 2022-25 (Rs Crore)



Is monetization beneficial?

Under-utilised assets

- E.g., A port or an empty piece of land that is not being used adequately.
- Here, the private player makes the necessary investment to make the asset more revenue-generating, and reaps the benefits from it.
- So, this is a win-win situation as -

1. the government gets a 'fair' value for its assets
2. the economy benefits from an increase in efficiency (increased cash flows from the asset)
3. the private player gets its return on investment

Well-utilised assets

- While NMP's focus is on under-utilised assets, the list of projects includes well-utilised assets also .E.g., monetising a highway that has good traffic.
- In this case, the private player has little incentive to invest and improve the assets' efficiency as –

1. anyways, it can operate the assets as they are
2. the cost of capital is higher (than that for a public authority), which could offset the benefit of any reduction in operating costs made

- In any case, the Government earns lesser revenues than what it might earn if it operated the assets itself.
- Clearly, the **benefits** are likely to be **greater when under-utilised assets are monetised.**
- Butprivate players will prefer well-utilised assets becausecash flows and returns are more certain.But this does not go well with the larger public interest.

Which is the effective mode (PPP or InvIT) of monetization?

Challenges in PPP [Public Private Partnership] route

- Getting the valuation of the assets right over a long-term horizon, say, 30 years is hard as this involves -

1. Rightly assessing the growth rate of the economy over such a period.
2. In case of roads - Other factors such as the level of economic activity in the area, prices of fuel and vehicles, alternative modes of transport and their relative prices, etc.

- In some cases, the consumer and the economy end up bearing the high cost.
- Also, the life of the assetmay not be long when the government receives it back after the agreement period.In that case, asset monetisation virtually amounts to sale.

InvIT - the Infrastructure Investment Trusts

- These are mutual fund-like vehicles. While in mutual funds, investors invest in equity stocks, in InvIT, the investment is in infrastructure projects.
- In the InvIT route, the public authority continues to own the rights to a significant portion of the cash flows and to operate the assets.
- So, the issues that arise with the transfer of assets to a private party (under PPP) are less here.

What should be done on the implementation side?

- The Government can set up an **Asset Monetisation Monitoring Authority** to independently monitor the monetization process.
- Staffed by competent professionals, the Authority should look into -
    1. the valuation of the assets
    2. the impact on price charged to the consumer
    3. the choices on assets (under-utilised or well-utilised assets)
    4. the experience across different sectors, etc.

8.20 Rural Debt Trap

Why in news?

The All-India Debt and Investment Survey (AIDIS) carried out by National Statistical Office gives an account on the rural credit market in India.

What does the report say?

- **Rural debt** - The average debt per household in rural India is Rs 59,748, nearly half the average debt per household in urban India**.**
- **Incidence of indebtedness (IOI)** - The IOI is 35 % in rural India — 17.8 % of rural households are indebted to institutional credit agencies, 10.2 % to non-institutional agencies and 7 % to both.
- **Rate of interest** - The rate of interest charged on 45 % of institutional debt is between 10-15 % whereas on 44 % of non-institutional debt falls between 20- 25 %.
- **Debt-Asset Ratio (DAR)** - DAR of the bottom 10% asset-owning households in rural India is 39, much higher than the DAR of 2.6 for the top 10 % households.
- **Expenditure** - The top 10 per cent rural households in terms of asset ownership spend most of the debt on farm/non-farm business, whereas the bottom 10 per cent it on household expenditure.

What can be inferred from the report?

- Easy and timely access to formal-sector credit enables households to invest in income-generating activities while non-institutional sources help to meet short-term consumption needs.
- Dependence on institutional sources signifies broadening **financial inclusion** while reliance on non-institutional sources denotes vulnerability and backwardness.
- In non-institutionalised debt, professional and agricultural moneylenders remain the primary sources of credit.
- Access to institutional credit is largely determined by the ability of households to furnish assets as collateral.

- Access to credit is complicated by the interplay of social identities as marginalised social groups have low asset ownership.
- Non-institutional sources have a strong presence in the rural credit market, notwithstanding the high costs involved in borrowing.
- Inadequate access to affordable credit lies at the heart of the rural distress.
- The credit policy needs to be revamped to accommodate the consumption needs of the rural poor and to find alternatives for collateral for rural financial inclusion.

8.21 National Financial Reporting Authority (NFRA): Auditors' auditor

What is the issue?

NFRA will be headless from October 1 if the government in the next two days does not announce either a successor or another term to the incumbent Chairman.

What is NFRA?

- The NFRA is a national regulator for auditors set up under the Companies Act, 2013.
- It was set up specifically to investigate the role of auditors in frauds in listed and large public interest entities.
- It came into being in late-2018 in the wake of the IL&FS financial scandal.
- **Composition -** NFRA will have a chairperson who will be appointed by the Central Government and a maximum of 15 members.
- **Role of NFRA**
    1. Make recommendations on the foundation and laying down of accounting and auditing policies and standards
    2. Monitor and enforce the compliance of the accounting standards and auditing standards
    3. Oversee the quality of service of professionals and suggest measures required for improvement in the quality of service
- **Powers of NFRA**
    1. To investigate the matters of professional or other misconduct committed by a prescribed class of CA firms or CAs
    2. The same powers as a Civil Court under the Code of Criminal Procedure, in specific matters.
    3. the power to impose penalty and debar a member/firm from practice as a member of ICAI
- Previously, only the Institute of Chartered Accountants of India (ICAI) can bar chartered accountants from being appointed as auditors for a company.
- Also, Securities and Exchange Board of India (SEBI) was permitted to bar CAs from auditing listed companies.

What were the actions taken by NFRA in the past 3 years?

- The three Audit Quality Reports (AQR) that NFRA has produced since 2018 called out the sub-standard audit practices followed by well-known audit firms.
- This was the first time in the country that audit practices were put under the scanner with such serious intent and analysed in such great depth.
- NFRA has recently found errors in KIOCL Ltd's financial statements pertaining to the fiscal year 2019-20.

What are the challenges in effective functioning of NFRA?

- Apart from Chairman, there is just one whole-time director on the board, and three part-time directors who are nominees of ICAI.
- The ICAI opposed the NFRA even before it was notified and also now after NFRA's AQRs that highlighted ICAI's ineffective regulation.
- Conflict of interest between Auditing and Assurance Standards Board (AASB) of ICAI and the Quality Review Board (QRB) of NFRA is an issue.

How to address these challenges?

- It is the government's responsibility to ensure its independence and autonomy — functional, financial and administrative.
- The government should streamline regulations under Section 132 of the Companies Act to increase the effectiveness of NFRA.
- NFRA needs an independent head who is not an ex or present office-bearer of ICAI.
- With greater participation of retail investors in the stock market and increasing shareholder activism, a strong and autonomous regulator is the need of the hour.

8.22 China's Evergrande crisis

What is the issue?

Chinese real estate conglomerate Evergrande Group has been in the news recently over its inability to pay interest on its huge debt obligations.

What is the trouble at Evergrande?

- The Evergrande Group is China's second-largest real estate company in terms of total sales and employs over 200,000 employees.
- Its core business deals with buying land, developing them into houses, restaurants and so on and selling them to interested buyers
- The company uses large amounts of debt from banks and investors as well as short-term loans to fund its business.
- It has total liabilities worth over $300 billion and has to pay around $37 billion in interest and maturing debt over the next year.
- Its share price has dropped over 80% in the last one year and hit a 10-year low.
- The company has also taken money in advance from buyers and from its own employees but has defaulted on these products

Why is the company in trouble?

- Almost a third of the Chinese GDP is made up of the property sector with Chinese authorities traditionally encouraging businesses to take on huge amounts of debts
- But the recent Chinese government's rules for property developers called '**three red lines**" that states how much a property developer can borrow given its financial position as measured by three debt metrics
- This policy practically cut off Evergrande from taking on any more debt on its balance sheet
- Some analysts argue that the company's business model has been unsustainable for a long time.
- It was said that the company held properties that it could not sell on its balance sheet as inventory to avoid booking of losses.
- The company was also accused of running a ponzi scheme as it needed constant inflow of funds to prop up a business model that is fundamentally unsustainable
- Many have called the Evergrande crisis **China's own 'Lehman moment'** where the failure of U.S. bank Lehman Brothers precipitated the 2008 financial crisis

What lies ahead?

- Any bailout by Chinese government will require the creation of a fresh supply of money which in turn will debase the value of the Chinese currency.
- Foreign investors with exposure to Evergrande may experience losses.
- Any slowdown in the Chinese economy in the course of rebalancement away from the property sector will have effects on the global supply chain.
- For instance, metal stocks in India have witnessed a sharp correction in attribution to fears of a slump in Chinese demand.

- Some critics have warned investors to refrain from investing in China pointing to the absence of the rule of law.
- Some analysts believe that Chinese growth could drop to as low 1-2% as the country massively rebalances its economy.

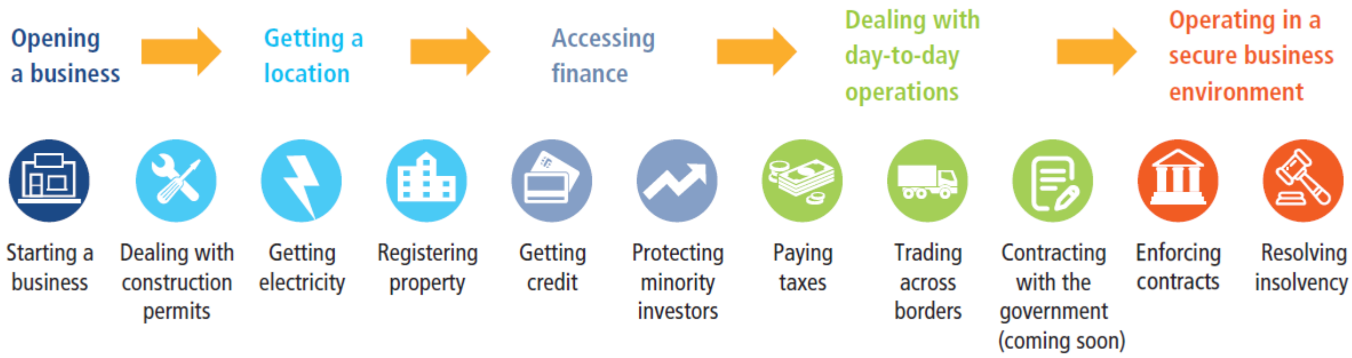
8.23 End of Ease of Doing Business Index

Why in news?

After data irregularities and possible ethical matters involving bank staff on Doing Business were reported , World Bank said that it would discontinue the report.

What is the index about?

- Ease of doing business is an index published by the **World Bank**.
- It is an aggregate figure that includes different parameters which define the ease of doing business in a country.
- The study covers 11 indicator sets and 190 economies.



What is India's rank in the report?

- India ranked low, around 130-140, till 2014.
- However, it zoomed to **63rd position** in 2019-20.
- The government's goal was to be among the top 50 economies by 2020.
- India along with other top improvers had implemented 59 regulatory reforms in 2018-19, accounting for a fifth of all reforms recorded worldwide.
- Showcasing the accomplishment, India has claimed success of '**Make in India'** campaign that sought to raise the manufacturing sector's share in GDP to 25% by 2022 (later revised to 2025).
- But there is a disconnect between the rise in EDB index rank and economic outcomes raising suspicion on data manipulation.
    - The annual growth rate in GDP manufacturing (at constant prices) fell to (-) 2.4% in 2019-20.
    - Net FDI inflow to GDP ratio has fluctuated around 1.5%.
    - The fixed investment to GDP ratio (at current prices) fell to 26.9% in 2019-20.

Comparing India's Ease of Doing Business (EDB) index rank with its economic performance

Year	EDB Index rank	GDP Mfg growth rate	Net FDI/GDP	GFCF*/GDP
2013-14	134	5.0	1.2	31.3
2014-15	142	7.9	1.5	30.1
2015-16	130	13.1	1.7	28.7
2016-17	130	7.9	1.6	28.2
2017-18	100	7.5	1.1	28.1
2018-19	77	5.3	1.1	29.0
2019-20	63	-2.4	1.5	26.9

*Gross fixed capital formation

Source: National Accounts Statistics, RBI Handbook Statistics on Indian Economy, and DPIIT, GOI

Why was the ranking so significant?

- Many countries showcase improved ranking to signal market-friendly policies to attract foreign investments.
- The Indian government weaponised the index to weaken labour regulations by dismantling official labour inspection systems and allowing employers to file self-regulation reports.

Why was the report flagged?

- Improper data changes were made and the involvement of bank staffers is reported to be the core cause for discontinuation of the report.
- The China's ranking was changed from 85th to 78th after intervention from the bank's top executives and their staffers.
- The parameter was altered to push Saudi Arabia's score in the list of top improvers for 2019.
- This also impacted the UAE's score because they followed a similar system.
- Chile's rank on the EDB index sharply rose when the conservative government was in power and went down when the socialists were ruling despite no changes in policies and procedures.
- For Azerbaijan, involvement from World Bank staffers is believed to have resulted in the country's score falling compared to previous years.

8.24 Boost to Man-Made Fibre Sector (MMF)

What is the issue?

Indian policy makers who had preferred cotton based textile policy over the decades are significantly moving towards man-made fibre sector (MMF)

How is the textile market of India?

- India is the largest producer of cotton in the world accounting for 25% of global output
- But, cotton yarn's share in the nation's export basket has halved since the turn of the century because of the shift from natural fibres like cotton to man-made fibres (MMF) such as polyester, viscose and Kevlar.
- India's share in MMF based readymade garment trade is a mere 2 per cent despite the fact that it is the second largest producer of MMF.

What steps have been taken to push the textile sector?

- The government removed the anti-dumping duty levied on purified terephthalic acid (PTA), a key raw material to make Polyester Staple Fibre .

- **Mega Investment Textiles Parks (MITRA) policy , 2021-** Under which seven large integrated textile parks, each spread over 1,000 acres, will be set up in the next three years benefitting both cotton and MMF segments.
- Recently, the government scrapped the anti-dumping duty on viscose staple fibre (VSF), a critical input for MMF textiles.
- **Remission of Duties and Taxes on Export Products (RoDTEP) scheme** – Introduced to reduce the tax burden on exporters and make them more competitive.
- **PLI scheme for textiles -** Focussing on MMF and technical textiles was announced involving incentives worth Rs.10,683 crore.
- To know more about PLI scheme for textile sector, click here

What measures will help India regain its dominance in textile exports?

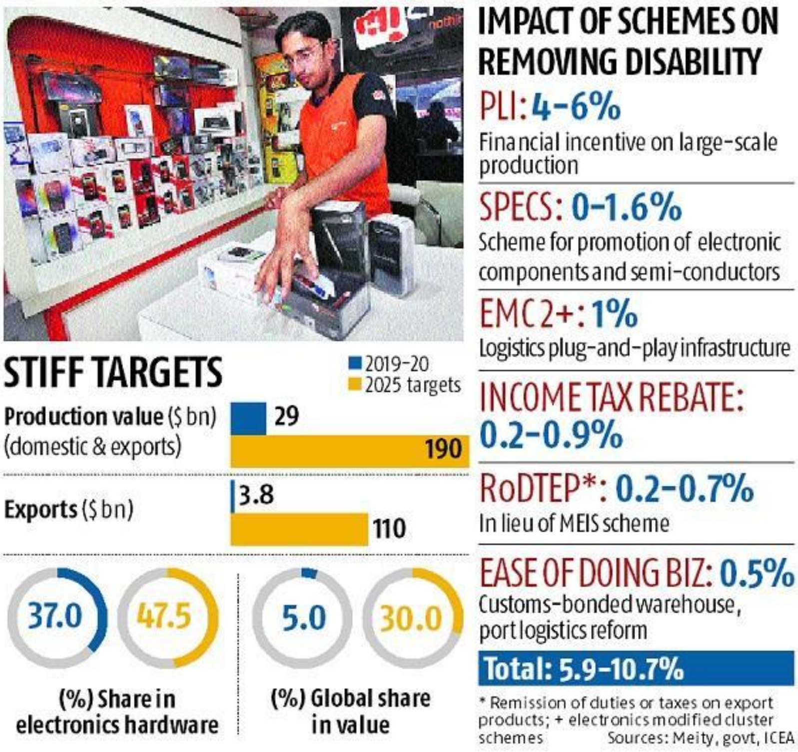
- The GST structure of MMF (GST on fibre is 18%,on yarn is 12 % and on fabric is 5 %) is inverted whereas GST for cotton is uniformly 5 % .
- A **fibre neutral policy** is required as MMF manufacturers are unable to take input credit in full.
- More reforms and investment in infrastructure are needed to bring the high logistics and labour costs.
- Automation, especially in readymade garments, will help increase productivity and reduce costs.
- To promote competitiveness among Indian exporters , government needs to incentivise them as like Bangladesh and Vietnam.
- There is a need to sign preferential trade agreements with importing countries. **Vietnam's FTA model** can be used for this purpose.

8.25 Catching up with China and South Korea in Electronics

What is the issue?

To make India a global hub for electronics manufacturing, the government must come up with more incentives beyond The National Policy on Electronics 2019

What is India's position with respect to electronics?



- Between 2015 and 2020, domestic electronics production jumped from $29 billion to $81.5 billion, a 23 per cent Compounded Annual Growth Rate (CAGR).
- India is the second largest manufacturer of mobile phones, though most of the components are imported.
- Now electronics manufacturing makes up **2.7 per cent** of India's GDP.
- This growth is attributed to the assembly of finished products from imported electronic components
- Electronics made up as much as 3.74 per cent of total exports in 2019-20.
- However, electronics imports fell only four per cent in 2019-20.
- Domestic demand for electronics hardware is expected to increase to around $400 billion by 2025.
- Even 10 per cent of this manufactured domestically would lead to significant revenue or employment being generated.

What are the issues in this sector?

- Inadequate infrastructure
- Domestic supply chain and logistics challenges
- High cost of finance
- Inadequate availability of quality power
- Limited design capabilities and focus on R&D by the industry
- Inadequacies in skill development

What initiatives have been taken to promote electronics manufacturing?

- **Modified Special Incentive Scheme (MSIPS) -** offers subsidies for electronics industry was launched in 2012.
- **Phased Manufacturing Programme** – was launched to promote use of locally made components in mobile phones.
- **Scheme for Promotion of Manufacturing of Electronic Components and Semiconductors (SPECS)-** aims to provide financial incentive of 25 per cent on capital expenditure for the identified list of electronic goods
- **PLI scheme -** provides a 4-6 per cent incentive on incremental sales of goods manufactured in India for a period of 5 years

What can we learn from China and South Korea?

China and South Korea control around 48 per cent of the electronics manufacturing market in the world

- The Chinese government has provided investment and grants of up to 60 per cent of project cost and even 50 per cent subsidies in R&D costs.
- South Korean government has provided financial support to specific clusters, fund for building plants, tax incentives, low-interest loans and duty-free import of select capital goods.
- India needs heavy investment in building the R&D ecosystem.
- To make India a global hub for electronics manufacturing, the government must come up with more short-term incentives.

9. INFRASTRUCTURE

9.1 Zero Termination Rate

Why in news?

The telecom industry moves to a new regime from 1 January 2021 with the interconnect usage charge (IUC) becoming zero.

What does this mean?

- A termination charge was paid to the operator on whose network the call terminated by the originating network.
- The new regime, where zero termination rate is payable, is known as bill and keep.
- With this, the operators will no longer have to pay the termination charge of 6 paise per minute to each other.

What impact will this have?

- The development would be revenue-neutral for all operators.
- This is because largely there is a symmetry by now between incoming calls to their networks and the outgoing to other networks.
- Till about a year ago, there was a symmetry between incoming and outgoing calls between the networks of Bharti Airtel and Vodafone Idea.
- However, in case of Jio, the number of outgoing calls was larger than incoming.
- Therefore, it was a net payer of IUC rather than net receiver.
- Reliance Jio was thus the only operator which charged its customers for termination of off-net calls (calls made to another network like Bharti Airtel or Vodafone Idea).
- While levying a termination charge for off-net calls in October 2019, Jio had said it would abolish it the day IUC becomes zero.
- With the new regime, Reliance Jio said it would no longer levy this charge.

What lies ahead for the telcos?

- The measure was delayed by a year by the regulator [TRAI] due to concerns that not all operators were ready.
- Also, the shift to more efficient 4G networks and compatible subscriber handsets was slower than anticipated.
- But now, the need to monitor call termination data and to make IUC payments no longer exists.
- Also, a spectrum auction is scheduled in 2021.
- Given these, the telecom companies can now focus on upgrading their networks and service.
- The focus should shift to giving the users a better deal such as reliable call quality and competitive tariffs.

How about the overall network status?

- India's high density telecom market is poised for further growth as it awaits expansion through 5G and Internet-connected devices.
- Yet, as the Economic Survey of 2019-20 pointed out, intense competition has reduced the number of private players.
- Public sector operators BSNL and MTNL still face a challenge.
- So, their future must be clarified early, with efforts to improve their technological capabilities and service levels.
- A parallel trend has been the rise in 4G subscribers [from 196.9 million in September 2017 to 517.5 million (out of a total wireless subscriber base of 1,165.46 million) in June 2019].
- The end of the IUC should encourage an expansion of high-capacity networks, going beyond 2G and 3G that some telcos continue to use.

What is the way forward?

- TRAI has always stressed the importance of consumer welfare through adequate choice, affordable tariff and quality service.
- So, it is now important to tread cautiously on claims made on behalf of the companies, that higher tariffs alone can ensure the health of telecoms.
- India is a mass market for voice and data services that fuel the digital economy.

- Badly priced spectrum could lead to auction failures. On the other hand, lack of genuine competition is bound to hamper the growth of the next big wave of telecoms. These should be addressed.
- On the consumer side, helping more people migrate to 4G services quickly through affordable handsets will help telcos put their infrastructure to better use.

9.2 Shipping Sector needs to be given due focus

What is the issue?

Despite India having significant coastline, it failed to realise the potential of shipping sector.

What is the concern regarding shipping sector?

- India once being a maritime supreme nation, now lost its global eminence in shipping due to poor legislation and politics.
- Whereas China which has coast only in east, is prominent in shipping due to its strong merchant marine and infrastructure to carry and handle merchandise all over the world.
- For instance, control of the seas is key component of China's Belt and Road Initiative & it is trying to take control of Bay of Bengal and Indian Ocean Region.
- The shipping infrastructure in peninsular India only helps foreign shipping liners.

How it helps foreign shipping liners?

- Colonial traders developed shore-based infrastructure to cater to the carrying capacity & there was balanced infrastructure onshore and at sea- road and rail connectivity -to facilitate their trade.
- Today foreign ship owners & agents carry inbound and outbound cargo and continue to exploit EXIM trade with enormous hidden charges in the logistics cycle.
- This is because India still did not optimise its carrying capacity so much of foreign currency is drained as transhipment and handling cost every day.
- Also members of our maritime business community prefer to be agents for foreign ship owners or container liners rather than becoming ship owners or container liners themselves.
- As a result, there is a wide gap between carrying capacity and multi-folded cargo growth in the country.
- Moreover relaxing "Cabotage" regulation will benefit only foreign container-carrying companies and not Indian ship owners.

What is the issue in shipping infrastructure?

- Indian bureaucracy has repeatedly allowed similar infrastructural developments in multiple cargo-handling ports rather than creating regional cargo-specific ports.
- As a result, Indian ports compete for the same cargo.
- If major ports are made cargo-specific with state of art infrastructure -connecting to hinterlands & international sea routes-, they will become transhipment hubs.
- Hence focus should on developing ports to serve the regional transhipment hubs for which small ship coastal operations needs to be improved.

How will Sagarmala programme will benefit shipping industry?

- It aims to enhance the performance of the country's logistics sector through port-led industrialisation, development of world-class logistics institutions and coastal community development.
- This will get reflected in domestic carrying capacity.
- Involving coastal communities will help in harnessing their century-old ship-owning spirit and sailing skills.
- Coastal communities will now be made as ship owners which will initiate carriage of cargo by shallow drafted small ships through coast and inland waterways.

What more can be done?

- With the call for 'Make in India' growing louder and simultaneous multi-folded cargo growth in the country, ships must to cater to domestic and international trade.

- Shipbuilding & Ship-owning spirit of the Indian merchant marine entrepreneur has to be restored & encouraged by the Ministry.
- The National Shipping Board an independent advisory body for the Ministry of Shipping needs to question the functioning of the Directorate General of Shipping (DGS).
- This DGS is responsible for promoting the carrying capacity in the country.
- In the coastal region, Sagarmala should concentrate on consolidating the strength youth population making them contribute to the nation's economy with pride.
- To make existing major ports as transhipment hubs, we need to develop balanced infrastructure in onshore & at sea.

9.3 Maritime India Vision 2030

What is the issue?

- Indian PM recently inaugurated the 'Maritime India Summit 2021,' also releasing the e-book of 'Maritime India Vision-2030' (MIV-2030).
- In this context, here is a look at the maritime sector in India and the scope of MIV-2030.

Why is the maritime sector in India significant?

- India's coastline is 1.05% of the global coastline.
- The Indian maritime sector accounts for 95% of EXIM (export-import) trade by volume.
- It is a significant employment generator.
- India accounted for 10.4% of global maritime trade in FY 2019.
- It contributes 9.03% of the total seafarers (officers) globally.
- This makes Indian an integral part of the shipping ecosystem.
- India's position in the global maritime sector is fundamental for international trade.

How is the port capacity being utilized?

- The maritime trade is facilitated by the growing port capacity in India.
- In FY 2019, the capacity for Indian ports stood at 2,377 million tonnes per annum (mtpa).
- It handled traffic of 1,281 mtpa.
- Twelve major ports accounted for 1,514 mtpa of capacity.
- They handled 699 mtpa of traffic, leading to utilisation of a mere 46.2%.
- Non-major ports accounts for 863 mtpa of capacity.
- They handled 582 mtpa of traffic, which is an utilisation of 67%.
- Thus, key enhancements in policy, investment, operations and technology are crucial.
- These will facilitate bringing India to the forefront of global maritime trade.

What does the Maritime India Vision 2030 entail?

- The ministry of ports, shipping and waterways has launched the MIV-2030.
- MIV 2030 projects cargo traffic to reach 2,570 mtpa by 2030.
- The vision outlines 10 broad themes.
- It encompasses 150+ initiatives covering all the facets of the Indian maritime sector.
- It comes as an effort to define and meet national maritime objectives.
- These initiatives are broadly aimed at development of port ecosystem, port operations and services, waterways and, shipping and cruises.

What are the projects/initiatives being planned?

- **Mega-port clusters** - For ports, world-class infrastructure will form the backbone of the envisioned transformation.
- In line with global trends of mega-ports, development of four mega-port clusters with capacity of more than 300 mtpa is planned.
- These will come in the states of Gujarat, Maharashtra, Tamil Nadu and West Bengal-Odisha.
- These clusters were post evaluation of industrialisation and hinterland-connectivity potential.
- Since the sector has been moving towards mega vessels, an increase of the draft at all major Indian ports is targeted.
- **Transshipment hub** - India's strategic location has long required development of a transshipment hub for better efficiency in maritime trade.
- The ministry would thus work towards developing a transshipment hub (TS) in South India.
- At present, approximately 75% of India's transshipment cargo is handled by ports outside India.
    - These include Colombo, Singapore and Klang.
- This increases the cost/TEU for EXIM players.
    - [A TEU or Twenty-foot Equivalent Unit is an exact unit used to measure cargo capacity for container ships and container terminals.
    - A TEU is a shipping container whose internal dimensions measure about 20 feet long, 8 feet wide, and 8 feet tall.]
- Therefore, there are plans to increase the transshipment capacity through -
    i. accelerated operationalisation of such ports
    ii. development of green-field TS ports at Kanyakumari and Campbell Bay as additional transshipment hubs in a phased manner
    iii. increase capacity of existing ports like Cochin
- **Procedural measures** - Automation of ports, seamless movement of cargo and paperless transactions are basic needs now.
- Currently, lack of digitalisation, lack of availability of real-time information and limited standardisation of port procedures are negatively impacting seamless trade.
- Hence, steps have been identified in MIV to improve ease of doing business in the maritime sector.
- A National Logistics Portal (Marine) is to be launched as an integrated platform for all EXIM stakeholders enabling 100% paperless processes.
- It will be the focal point for domestic shipment tracking, cloud-based document management, digital payments, etc.
- Additionally, more than 50 smart interventions, like predictive maintenance, deployment of automated quay cranes, etc, have been identified to transform major ports into smart ports.
- **Manufacturing and logistics** - Concrete steps have been identified for driving Aatmanirbhar Bharat through increased manufacturing and decreasing logistics cost.
- Pockets with high potential to undertake port-led industrialisation, spread over 6,000 acres, have been identified.
- This would be complemented with projects aimed at reducing logistics cost.
- E.g. development of commodity-specific infrastructure at ports for promoting coastal shipping, automation/mechanisation of operations
- **Environment friendly** - MIV-2030 also aims at building safer and environmentally-sustainable ports.
- Some of the key measures to develop Green Ports include -
    i. increased share of renewable energy in port operations
    ii. sustainable use of dredging material

iii. reducing freshwater consumption and emissions
iv. promoting development of 'zero accident' ports
v. real-time monitoring of HSE KPIs [Health and Safety KPIs (Key Performance Indicator)]

- **Shipping -** On the shipping front, MIV aims to make India the leading ship recycling and repair hub.
- It also aims to increase the gross tonnage of ships built in India by more than 15 times.
- This would be achieved through -
  i. channelization of domestic demand for ship-building and repair
  ii. leveraging Right of First Refusal (RoFR) rules under Aatmanirbhar Bharat Scheme
- India has already demonstrated strong ship-building capability with several shipyards delivering good quality vessels globally.
- Repair and recycling clusters would be developed.
- For this, usage of scrap material will be promoted through modification of BIS (Bureau of Indian Standards) regulations and re-development of ship recycling infrastructure at Alang.
- **Trade and cooperation** - To increase regional maritime cooperation and trade, a BIMSTEC centre is planned to be established in India.
  - BIMSTEC - Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation
- It would facilitate infrastructure investment and trade agreements with BIMSTEC countries.
- Efforts would also be made to develop and export India's core competencies like IT, naval architecture, and maritime training to support other developing countries.
- **Inland water transport** - India is endowed with various Inland Water Transport (IWT) options comprising rivers, canals, backwaters, creeks, and tidal inlets.
- These provide environmentally-friendly mode of freight logistics and passenger transport with lower operating costs.
- The government has prioritised development, over the next 10 years, of 23 National Waterways (NWs) with significant traffic potential.
- NW 1 (Ganga-Bhagirathi-Hooghly system) and NW 2 (Brahmaputra) hold immense significance as they connect neighbouring countries with India's hinterland.
- These waterways are to be connected to form the Eastern Waterways Connectivity Transport Grid.
- This would provide cost-effective EXIM with Bangladesh, Bhutan, Myanmar and Nepal.
- **Cruise tourism** - Development potential of sectors like cruise tourism (both river & ocean cruise) has also been identified as a part of the vision.
- To this end, government has already undertaken several measures like rationalisation of port charges, cabotage relaxation for foreign vessels, expedited immigration and development of cruise terminals.
- Themes-based coastal and island circuits have also been identified on a priority basis.
- In all, MIV 2030 aims to increase the share of Indian seafarers in the global talent pool.
- Advancements in maritime trade would lead to evolution in capabilities for on-shore operations.
- Accordingly, training programmes focusing on maritime skills would be launched in partnership with industry.

9.4 DoT's Green Signal for 5G Trials

Why in news?

The Department of Telecommunications allowed private telcos and state-run telco MTNLto start trials for 5G technology as well as its applications in various sectors.

Which firms are allowed?

- Privatetelecos (telecommunication companies)include Bharti Airtel, Reliance JioInfocomm and Vi (formerly Vodafone Idea).
- State-run telco Mahanagar Telephone Nigam Limited (MTNL) is also allowed to conduct trials.
- The trials will last for 6 months for now.
- 5G or fifth generation is the latest upgrade in the long-term evolution mobile broadband networks.
- 5G mainly works in 3 bands, namely low, mid and high-frequency spectrum, all of which have their uses and limitations.

Why are the trials for 5G technology important?

- The telecom market in India is left with only three private telcos.
- The rest have surrendered to the low returns on investments over the years.
- Apart from the privatetelecos, the two state-run companies, MTNL and Bharat Sanchar Nigam Limited (BSNL) have also survived but are making losses.
- In order to increase their average revenue per user, it is pertinent for telcos to start offering the new 5G technology as soon as possible.
- For that, however, they will have to conduct trials in a variety of circumstances.
- Apart from the telcos, it is also important that the government be ready to roll out the new technology as soon as possible.
- The telecom sector already faces issues such as –
    i. delays in approvals
    ii. inadequate availability of spectrum
    iii. high spectrum prices
    iv. poor development of use cases
    v. low status of fiberisation, among others
- So, India could miss the 5G opportunity if not for early measures and programmes.

How will the trials be carried out?

- In the initial phase, these trials will be for 6 months.
- This includes a 2 month period for procurement and setting up of the equipment.
- In these 6 months, telcos will be required to test their set up in urban areas, semi-urban areas as well as rural areas.
- During this period, the telcos will be provided with experimental spectrum in various bands.
- The mid-band of 3.2 GHz to 3.67 GHz, the millimeter wave band of 24.25 GHz to 28.5 GHz, and others.

What are the advantages and limitations with these bands?

- The low band spectrum has shown great promise in terms of coverage and speed of internet and data exchange.
- But the maximum speed is limited to 100 Mbps (Megabits per second).
- This means that telcos can use and install it for commercial cellphone users who may not have specific demands for very high speed internet.
- However, the low band spectrum may not be optimal for specialised needs of the industry.
- The mid-band spectrum, on the other hand, offers higher speeds compared to the low band.
- But it has limitations in terms of coverage area and penetration of signals.
- Telcos and companies, which have taken the lead on 5G, have indicated that this band may be used by industries and specialised factory units.
- This would help build captive networks that can be moulded into the needs of that particular industry.

- The high-band spectrum offers the highest speed of all the three bands, but has extremely limited coverage and signal penetration strength.
- Internet speeds in the high-band spectrum of 5G has been tested to be as high as 20 Gbps (giga bits per second).
- On the other hand, in most cases, the maximum internet data speed in 4G has been recorded at 1 Gbps.

What were the issues resolved?

- In June 2019, the DoT had first approved 5G trials.
- However, there were multiple issues that came in the way.
- For instance, there was no clear roadmap of spectrum availability and 5G frequency bands aligned with the global standards.
- Typically, a 5G operator needs a contiguous block of 100 MHz of spectrum to offer any meaningful service.
- This meant the 175 MHz earmarked for 5G was grossly inadequate. This has now been resolved.
- There was also no clarity on whether Chinese equipment vendors, including Huawei and ZTE, will be allowed to supply 5G gear to Indian operators.
- This also has now been clarified with the DoT barring Chinese vendors from the trials.
- Over the past year, a number of Indian companies have developed 5G capabilities.
- The proposed trials will be a good opportunity to prove that these indigenous platforms can be viable alternatives to the Chinese vendors.

What are the concerns to be addressed?

- There is a need to move away from the existing mechanism of pricing spectrum on a per MHz basis.
- If the Centre were to fix the floor price based on the per Mhz price realised in the last auction, then no operator would be able to afford 5G spectrum.
- The Centre must also address the issue of financial stress in the sector to avoid a duopoly.
- The Centre should help by lowering licence fees and spectrum usage charges.
- With this, telecom companies can free up capital that can then be invested in network expansion.
- Finally, the regulator must ensure that operators are meeting the quality of service parameters of existing 2G and 4G networks before embarking on a new 5G platform.
- Consumers are still grappling with issues like voice call drops and interrupted data services.

9.5 Infrastructure push for Railways

What is the issue?

The National Rail Plan prepared by Indian Railways along with other projects can have a transformative effect in the infrastructure of railway system.

What are the recent optimisms in the railway sector?

- Indian Railways recorded the highest ever annual freight loading of 1,233 million tonnes (mt) in 2020-21, exceeding the preceding year's 1,210 mt.
- Railway staffs have operationalised the Oxygen Expresses, delivering more than 30,000 tonnes of liquid medical oxygen amidst the pandemic.

What is the National Rail Plan about?

- National Rail Plan (NRP) for India aims to create a **'future ready'** Railway system by 2030
- Keeping the year 2050 as the horizon, NRP charts out a strategic grid for Railways to follow for the short term (up to 2024), medium term (up to 2031) and long-term.
- Intends to increase modal share of the Railways in freight to 45%.
- Reduce the transit time of freight substantially by increasing average speed of freight trains to 50Kmph.

- Identify new Dedicated Freight Corridors and new High Speed Rail Corridors.
- A cumulative outlay for the entire plan period 2021-51 is estimated at Rs.38,20,516 crore.

Does the expectation in the document appear realistic?

- The aim to grab 45 % of the country's freight market by 2030 (from the current 26 %) which is predicated on its carrying capacity appears unrealistic.
- NRP's bold statement that the revenue surplus generated by the Railways would be adequate to finance future capital investment post 2030 is under question.

How can the railways achieve the ambitious objectives set out in the NRP?

- Need to address productivity and efficiency indices in order to maximise resource utilisation and improve average system velocity.
- Need to cater to freight transport demand of other commodities (non-conventional as well as conventional high-value) through appropriate interventions for enhancing the modal share.
- A single window, end-to-end solution for logistics services as demanded by the customers.
- Partnering of Railways with logistics service providers to leverage their superior market access and flexible parcel sizes through consolidation services.

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