

Shyamala Gopinath: Foreign exchange regulatory regimes in India - from control to management

Address by Ms Shyamala Gopinath, Deputy Governor of the Reserve Bank of India, at the Conference organised by the Forum for Free Enterprise, Mumbai, 25 January 2005.

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Shri Minoo Shroff, Mr Gazaria, Mr. Thakkar, ladies and gentlemen.

I am delighted to be here in Forum of Free Enterprise to deliver the keynote address at this programme on FEMA for executives and professionals. The Forum of Free Enterprise has been engaged in educating public focusing special attention on the youth with a view to helping today's younger generation to become good, responsible, active and well informed citizens of tomorrow. Towards that end stalwarts like the late A.D. Shroff, the late Murarji J. Vaidya, the late Nani Palkhiwala and the late M. R. Pai had played a great role.

In my address, I would like to set out the rationale of the liberalisation and simplification of process and procedures for foreign exchange transactions. What has been the philosophy behind India's policies in regard to the external sector? What are the current challenges for India as it integrates with the global economy? What has been the policy measures taken for simplification and liberalisation of process and procedures for foreign exchange transactions? In the present address I intend to cover some of these questions.

Context of foreign exchange regulations

There is a German word called *zeit-geist* which, I am told, can broadly be translated as the 'spirit of time'. Nothing better describes the evolution of foreign exchange regulation in India. Let me start with a brief brush of history. Soon after independence, a complex web of controls were imposed for all external transactions through a legislation i.e., Foreign Exchange Regulation Act (FERA), 1947. These were put into a more rigorous framework of controls through FERA, 1973. Severe restrictions on current account transactions had continued till mid-1990s when relaxations were made in the operations of the FERA, 1973. The control framework was essentially transaction based in terms of which all transactions in foreign exchange including those between residents and non-residents were prohibited, unless specifically permitted.

Control- to- management: FERA-to-FEMA

In the 1990s, consistent with the general philosophy of economic reforms a sea change relating to the broad approach to reform in the external sector took place. The Report of the High Level Committee on Balance of Payments (Chairman: Dr. C. Rangarajan, 1993) set the broad agenda in this regard. The Committee recommended, *inter alia*, the introduction of a market-determined exchange rate regime within limits; liberalisation of current account transactions leading to current account convertibility; compositional shift in capital flows away from debt to non debt creating flows; strict regulation of external commercial borrowings, especially short-term debt; discouraging volatile elements of flows from non-resident Indians; full freedom for outflows associated with inflows (i.e., principal, interest, dividend, profit and sale proceeds) and gradual liberalisation of other outflows; and dissociation of Government in the intermediation of flow of external assistance, as in the 1980s, receipts on capital account and external financing were confined to external assistance through multilateral and bilateral sources.

The sequence of events in the subsequent years generally followed these recommendations. In 1993, exchange rate of rupee was made market determined; close on the heels of this important step, India accepted Article VIII of the Articles of Agreement of the International Monetary Fund in August 1994 and adopted the current account convertibility. In June 2000 a legal framework, with implementation of FEMA, has also been put into effect to ensure convertibility on the current account. As emphasized by the Rangarajan Committee that there could be capital outflows from residents in the guise of current

account transactions after current account convertibility, certain safeguards were also built into the system after FEMA came into effect. For example:

- First, the requirement of repatriation and surrender of export proceeds was continued, with provision of Exchange Earners Foreign Currency (EEFC) account for use by exchange earners.
- Second, all authorized dealers were allowed to sell foreign exchange for underlying current account transactions supported by documentary evidence.
- Third, a proactive approach in the development of money, government securities and forex markets has been adopted.
- Fourth, effort has been made to improve the information base on transactions in the forex markets with respect to its nature and magnitude through reports and statements. The insistence on adequate and timely reporting requirements from authorised dealers for various foreign exchange transactions also helped in simplification and liberalisation process.
- Fifth, as a general rule, genuine hedging of exposures under specified conditions is allowed.

This consistent approach has lent credibility to the liberalisation process of both current and capital account transactions.

In 1997, the Tarapore Committee on Capital Account Convertibility (CAC), constituted by the Reserve Bank, had indicated the preconditions for Capital Account Convertibility. The three crucial preconditions were fiscal consolidation, a mandated inflation target and, strengthening of the financial system. Drawing from the lessons of international experience, the Committee noted that, in general, countries which initiated the move to CAC on the basis of strong fundamentals were able to modulate the pace of instituting CAC without undertaking large and dramatic shifts in the stance of macro economic policies. Furthermore, these countries were less vulnerable to backtracking and the reimposition of controls in the face of exogenous shocks. In fact, the pursuit of reforms in other areas by these countries instilled confidence in the process of opening up of the capital account. Countries with weak initial conditions have to adopt drastic measures in macro economic policies to facilitate the move to CAC. Some of these countries had to face interruptions and reintroduction of capital controls in the evolution of CAC. In this context, I recall the observations of former Governor, Dr. Bimal Jalan and I quote, "...It must be understood that merely by lifting all capital controls, the markets of a developing country do not get as deeply integrated as a developed country's markets. As such, each country would need to decide on its own path of capital account liberalization with regard to the timing and sequencing".

The Tarapore Committee had also recommended change in the legislative framework governing foreign exchange transactions. Accordingly, the Foreign Exchange Regulation Act (FERA) which formed the statutory basis for exchange control in India was repealed and replaced by the new Foreign Exchange Management Act (FEMA) with effect from June 2000. The philosophical approach has shifted from that of conservation of foreign exchange to one of facilitating trade and payments as well as developing orderly foreign exchange market. This definitive shift in the objectives of foreign exchange management could be seen in the preamble to the new legislation.

FEMA provided a *de jure* status to the shift in the policies with regard to the external sector reforms that began in 1990-91. Further and more importantly, FEMA has diluted the rigorous enforcement provisions which were the hallmark of the erstwhile legislation. Unlike in FERA, the prosecution has to prove the guilt of the accused person. Further, under FEMA only monetary penalty are provided for contraventions. The categorisation of offences under FEMA as civil and not criminal constitutes one of the most important differences between the two statutes. Contravention of FEMA provisions are dealt with under civil law procedures, for which separate administrative procedure and mechanism in the form of Compounding Rules, Adjudicating Authority, Special Director (Appeals) and Appellate Tribunal have been established. Another significant change has been that for each process of law a time-frame has been provided in the Act. For example, the process of compounding is required to be completed within 180 days.

The concept of compounding in FEMA is another distinguishing feature, especially from the perspective of customers. Under FERA, all violations were subject to separate investigation and adjudication of the Directorate of Enforcement. However, FEMA provides for an opportunity of seeking compounding of contraventions, in terms of which a contravener has a *suo moto* opportunity of making

an application to the compounding authority seeking the contravention to be compounded. The compounding authority is required under the Act to dispose of the application within 180 days. The Government of India, in one of its recent Notifications, has designated the Reserve Bank as the compounding authority for all contraventions, except for those involving *hawala* transactions for which the Directorate of Enforcement would be the compounding authority. The Reserve Bank is in the process of issuing the necessary direction for implementation of the process for compounding of contravention under FEMA. I am sure the new procedure will go a long way in providing a quick and hassle-free disposal of cases involving contravention(s) of FEMA.

Having delineated the context let me now turn to specifics of capital account liberalisation and the accompanying challenges.

Capital account liberalization approach

Globalization of the world economy is a reality that makes opening up of the capital account and integration with global economy an unavoidable process. Today capital account liberalization is not a choice. Governor, Dr. Reddy once commented that, "capital account liberalisation is a process and it has to be managed keeping in view the elasticity in the economy, and vulnerabilities or potential for shocks. These include fiscal, financial, external, and even real sector say, oil prices and monsoon conditions for India."¹

The capital account liberalization primarily aims at liberalizing controls that hinder the international integration and diversification of domestic savings in a portfolio of home assets and foreign assets and allows agents to reap the advantages of diversification of assets in the financial and real sector. However, the benefits of capital mobility come with certain risks which should be categorized and managed through a combination of administrative measures, gradual opening up of prudential restrictions and safeguards to contain these risks.

The discussion on capital flows and monetary policy inevitably begins with the well-known "trilemma" or the impossible trinity in the sense that a country can choose no more than two of the following three features of its policy regime: (1) free capital mobility across borders, (2) a fixed exchange rate, and (3) an independent monetary policy. Various combinations of these features have dominated world monetary arrangements in different eras. The question of how developing and emerging-market countries like ours should resolve the trilemma is very crucial. At best a medium-term goal of achieving free capital mobility could be set with measured steps and optimal control.

Recent policy initiatives

India adopted a gradualist approach while initiating a process of gradual capital account liberalisation in the early 1990s and treated it as a process rather than an event. In recent past, there has seen significant changes in the external sector policy of the Reserve Bank. The Department concerned of the Reserve Bank has been rechristened from the Exchange Control Department to Foreign Exchange Department, highlighting the change in the intent and content of the policy framework. Let me assure you that this change is not just a matter of semantics but is reflective of the changed mind-set. The focus of the measures has been to dismantle controls and provide an enabling environment to all entities engaged in external transactions. The current approach to liberalisation has been characterized by greater transparency, data monitoring and information dissemination and to move away from micro-management of foreign exchange transactions to macro management of forex flows and forex market. The emphasis of the Reserve Bank has been to ensure that procedural formalities are minimised so that exporters and others are able to concentrate on their core activity rather than engaging in avoidable paper work, while ensuring observance of Know-Your-Customer (KYC) guidelines.

The details of the various initiatives taken by the Reserve Bank will be discussed later by other speakers. Let me, for the sake of completeness, present a quick run-down of the significant policy measures in this context:

¹ Remarks on Capital Account Liberalisation and capital controls by Dr. Y. V. Reddy, Governor, Central Bank Governors' Symposium, 2004, Bank of England, June 25, 2004.

Investment overseas

To further the process of capital account liberalisation, steps were taken to encourage the strategic presence of the Indian corporates overseas. Overseas investment are also permitted for undertaking agricultural activities including purchase of land incidental to this activity either directly or through the overseas offices. These measures would enable the Indian companies to take advantage of global opportunities and also acquire technological and other skills for their adoption in India. Indian companies are now free to invest up to their net worth outside India without any ceiling.

External commercial borrowing

Keeping in view India's external sector position, as reflected in country's various external debt sustainability indicators, a comprehensive review of the ECB guidelines was carried out in consultation with the Government and revised ECB guidelines, effective February 1, 2004, were announced to encourage corporates to access ECB for undertaking real investment activity in India and for overseas direct investment in JVs and Wholly Owned Subsidiary (WOS). The maximum amount of ECB that can be accessed under the Automatic Route is enhanced to USD 500 million (from USD 50 million previously) per financial year. Further, transparency in policy implementation is evident from the fact that the Reserve Bank now posts data of all ECB raised, both through the automatic route and the approval route in the public domain on its website for information of all concerned. The thrust of the new policy is to encourage investment in the real sector including infrastructure, while restricting debt flows for purposes other than those adding to the country's capital stock. Higher amount can be accessed with prior approval of the RBI.

Foreign Direct Investment: The FDI policy followed has been to encourage investment in manufacturing and infrastructure. A person resident outside India or an incorporated entity outside India can invest either with the specific prior approval of the Government of India (12 activities), or under the Automatic route (21 activities). There are 11 activities in which investment is not permissible. Investment under automatic route is permissible without approval of the Government or the Reserve Bank subject to the prescribed sectoral cap.

Portfolio Investment: Foreign Institutional Investors (FIIs) registered with SEBI and Non-resident Indians are eligible to purchase shares and convertible debentures under the Portfolio Investment Scheme subject to certain limits.

ADR/GDR: An Indian corporate can raise foreign currency resources abroad through the issue of American Depository Receipts (ADRs) or Global Depository Receipts (GDRs) subject to certain conditions. Two-way fungibility of ADRs/GDRs was operationalised to bring about alignment in the prices of Indian stocks in the domestic vis-à-vis international markets.

Non-Resident Deposits: There have been significant changes in the policy framework for non-resident Indian (NRI) deposits held by the Indian banking system, which constitute a major portion of external debt for India. The interest rate on the deposits were rationalized and linked to international benchmark LIBOR.

Liberalised remittance of USD 25,000 p.a. by Resident Individual: In order to provide hassle free remittance facility based on a declaration resident individuals were allowed in early 2004 to remit up to USD 25,000 per annum for any permitted purpose both under current and capital account or combination of both. Resident individuals were also permitted to acquire property overseas and open accounts with banks outside India.

Students: Indian students studying abroad are treated as Non-Resident Indians. As non-residents, they are eligible for all the facilities available to NRIs, in addition to remittance facilities presently available to students as residents.

Procedural simplifications

No liberalisation effort is complete unless the customers or the end-users of the forex market can access the same through simple and transparent procedures. A number of initiatives have been taken towards procedural simplification with an objective of reducing the transaction cost. In the case of individuals, foreign exchange for current account transactions such as education, medical, travel, emigration, maintenance of close relatives abroad can be drawn from the Authorised dealer based on simple declaration up to certain indicated limits. Having regard to the liberalised approach in trade matters, specific steps were taken to allow exporters greater flexibility and freedom in the matter of

seeking regulatory compliances. The system of self write off and self extension of due date for export realisation for exporters was introduced followed by raising the threshold limit for GR declaration. Similarly, the simplifications of procedures for import remittances have also been introduced. Overall, measures for simplification of procedures have been made subject to KYC and Anti Money Laundering guidelines.

In keeping with its commitment to ensure hassle-free service to the customers the Reserve Bank has constituted the Committee on Procedures and Performance Audit on Public Services (CPPAPS) (Chairman: Shri S.S. Tarapore) in December 2003 to address the difficulties faced by common persons in getting services from the banking sector. The Reserve Bank also advised banks to constitute an adhoc committee in each of them to review the procedure followed by them and to ensure that the instructions issued by the Reserve Bank are properly implemented. The CPPAPS, in its Report No.1 on **Exchange Controls relating to the Individuals**, focused its attention on the assessment of facilities and procedures for both residents and non-resident individuals. The recommendations of the CPPAPS have been examined by the Reserve Bank and a number of steps had already been taken for their implementation, securing procedural simplification. Further, measures have been initiated to institutionalise the system for procedural simplification in respect of foreign exchange transactions both at the level of the Reserve Bank and authorised dealers.

In recent years, the Reserve Bank has delegated authorities to authorised dealers to such an extent that there is hardly any need for the individuals to approach the Reserve Bank for any approval. However, we have come across instances where the liberalised procedures have not permeated to the grassroot level in banks possibly due to lack of knowledge about various rules and regulations and also procedures to be followed for various types of forex transactions. While, we at the Reserve Bank would continue our efforts to improve the customer service rendered at the Reserve Bank and banks, I request that any difficulties in getting facilities which are permissible may be brought to the notice of the Reserve Bank.

Way ahead

India's capital account liberalisation measures have been largely effective. Among other factors, suitable policy measures in respect of the external sector insulated India from the 1997 Asian crisis. We have moved forward gradually towards Capital Account Convertibility with a broad reform agenda that encompasses trade, competition, reform of the financial system and industrial restructuring.

As evident from various economic indicators, the liberalisation process that has been underway for some time created a more competitive environment for Indian industry vis-à-vis what existed earlier. Consequently, the Indian companies have upgraded their technology and expanded to more efficient scales of production and refocused their activities to areas of competence. Increasingly, Indian companies are looking to become global players. Reform measures in the external sector, including dismantling of exchange control have been a contributor to this development.

We would continue to participate actively in the process of economic and financial globalisation, accelerate domestic economic reform and continue with our firm commitment to liberalisation so as to serve the needs of economic growth and development of the country. An increasingly liberalising foreign exchange regulatory regime will be an essential ingredient to this vision.

Thank You.