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Foreign Exchange Market and Management of the Capital Account

Introduction

Between 1997 and 2008, the Indian foreign exchange (or forex) market underwent a major transformation in terms of the scale of turnover, players, institutional arrangements, and instruments. Although the Indian rupee had become convertible on current account in 1994, some of the current account transactions were still subjected to limits. These were either removed or relaxed subsequently and brought under a new legal framework, the Foreign Exchange Management Act (FEMA), 1999, which replaced the earlier, and far more restrictive, Foreign Exchange Regulation Act (FERA) 1973. Authorised dealers (ADs) were provided with more flexibility to undertake forex operations and greater freedom to manage risks.

The liberalisation of the capital account, by contrast, was a more gradual process and marked by cautious optimism. The period witnessed 'effective' full capital account convertibility for non-resident Indians (NRIs) and the introduction of limited liberalisation measures for capital transactions of residents. The underlying aim was to open up the forex market in line with the ongoing reforms. That expectation was so well fulfilled that the resultant transition posed problems for capital account management. Between 2001 and 2008, capital inflows occurred on a scale beyond the absorbing capacity of the economy, forcing the Reserve Bank to explore ways in which the 'problem of plenty' could be handled (Table 4.1).

In terms of the powers conferred by FEMA, the Reserve Bank is responsible for development and regulation of the forex market as well as management of the capital account. The measures that were taken to further open up the market during 1997–2008 necessitated changes in the legal framework and introduction of a large number of specific regulatory measures on the part of the Bank. The focus of the present chapter is on these measures.

Table 4.1 Select Indicators of External Sector

(per cent of GDP)

Year	*Exports*	*Imports*	*Private Transfers*[a]	*Software Exports*	*Current Account Balance*	*Foreign Investment (Net)*	*Net Capital Flows*
1997–98	8.4	12.1	2.8	0.4[b]	-1.3	1.3	2.3
1998–99	8.0	11.1	2.4	0.6[b]	-0.9	0.5	2.0
1999–2000	8.0	11.9	2.6	0.9[b]	-1.0	1.1	2.2
2000–01	9.5	12.2	2.7	1.3	-0.5	1.2	1.9
2001–02	9.1	11.4	3.2	1.5	0.7	1.4	1.7
2002–03	10.3	12.3	3.3	1.8	1.2	0.8	2.1
2003–04	10.7	12.9	3.6	2.1	2.3	2.2	2.7
2004–05	11.8	16.5	2.9	2.4	-0.4	1.8	3.9
2005–06	12.6	18.8	3.0	2.8	-1.2	1.9	3.0
2006–07	13.6	20.1	3.2	3.3	-1.0	1.6	4.7
2007–08	13.4	20.8	3.5	3.2	-1.3	3.5	8.6

Source: RBI, Database on Indian Economy.

Notes: a. Migrants transfer. b. Based on National Association of Software and Service Companies (NASSCOM) data.

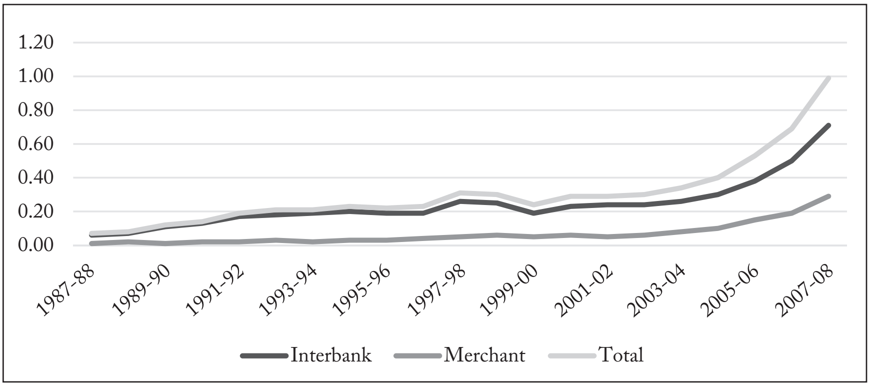
The rest of the chapter has two main sections, dealing with the forex market and management of the capital account.

Foreign Exchange Market

Until the late 1990s, the Indian forex market was relatively shallow and had an uneven flow of demand and supply. Most transactions were spot and trade based. Transactions emanating from market expectations were rare because arbitrage opportunities between onshore and offshore financial asset markets were not freely allowed to be exploited. Interbank transactions were not significant as there were many restrictions on forex transactions of the banks. 'Forward' contracts were allowed only with underlying transactions and did not exist for a tenure beyond six months. As such, turnover in the Indian forex market was low (Figure 4.1).

Figure 4.1 Turnover in Indian Foreign Exchange Market

(per cent of GDP)



Source: RBI.

There were a few major players in the market. In 1997, 40 per cent of the total value of customer transactions was accounted for by State Bank of India (SBI), and the remaining shared by other public sector banks. In the interbank segment of the market, only SBI and a few other banks were ready to quote two-way price both in the spot and forward markets and they were regarded as market makers. The Reserve Bank intervened in the forex market either to buy or sell forex, as the case may be, to meet the deficit, or to absorb the surplus, thereby playing the role of market stabiliser.

In terms of types of transaction, debt service payments and imports were major components of forex outgo. Demand for forex came mainly from oil companies and other public sector enterprises. In terms of supply, export of goods and services was the major contributor. From the late 1970s, workers' remittance had also gained prominence as an inflow. As capital transactions were restricted, only traditional components, such as official capital flows and NRI deposits, formed the major part of capital flows. Foreign direct investment (FDI), though allowed, was limited to a few sectors, subjected to sectoral caps, and not encouraged without technology transfer. In terms of ratio to gross domestic product (GDP), total current and capital transactions were only around 44 per cent in 1996–97 compared to nearly 114 per cent in 2007–08. Transactions were closely regulated.

The genesis of forex regulation in India goes back to the 1930s when the Defence of India Act, 1939, was passed because of the scarcity of forex in the aftermath of the Great Depression. An independent legislation, FERA, 1947, empowered both the government and the Reserve Bank to control and regulate receipts and payments of forex. While all current transactions were regulated by the Bank, capital transactions were controlled by the government. The government dealt with contraventions of FERA. FERA, 1947, was replaced by FERA, 1973. The new law contained more stringent controls on forex transactions. FERA was repealed in 1999 and FEMA, 1999, was passed, which was liberal and more conducive to external trade and investments.

India had a fixed exchange rate arrangement until the mid-1970s. From 1975 to 1992, the Reserve Bank set the exchange rate of the rupee in terms of a weighted basket of currencies of India's major trading partners. There were significant restrictions on current account transactions and only a few transactions were allowed under the capital account. The Bank was ready to buy and sell forex to tide over the mismatch between demand and supply. After an interim arrangement of dual exchange rate arrangement under a Liberalised Exchange Rate Management System (between 1 March 1992 and 28 February 1993), the exchange rate was unified from 1 March 1993, which heralded a new era of a market-determined exchange rate. This, together with the relaxations of restrictions on the current transactions, culminated in the announcement of current account convertibility in 1994.[1]

There is a large scholarship on the liberalisation process from the early 1990s so that another descriptive account of the process can be avoided here. Instead, this chapter focuses on the role of the Reserve Bank in leading the transition.

Reviews and Recommendations

The discussion can begin with the step taken by Governor Rangarajan in November 1994 to set up an Expert Group on Foreign Exchange under the chairmanship of O. P. Sodhani, Executive Director. The committee, which submitted its report in June 1995, made several recommendations that became a blueprint for forex market reforms introduced in 1996. Some of the recommendations of the committee, such as allowing the ADs to use derivative products, changed the structure of the market. In his 1997–98 Budget speech, Finance Minister P. Chidambaram announced that he would be asking the Reserve Bank to appoint a group of experts to lay out the road map towards capital account convertibility. The Bank appointed the Committee on Capital Account Convertibility, popularly known as Tarapore I, under the chairmanship of S. S. Tarapore, former Deputy Governor.

The committee's report, which was submitted on 30 May 1997, recommended a phased implementation of capital account convertibility in a three-year time frame beginning 1997–98 (Box 4.1). The committee recommended a gradual liberalisation of controls on capital outflows and inflows, which had a bearing on the forex market.[2]

Box 4.1 Tarapore Committee I (1997)

The setting up of the Committee on Capital Account Convertibility (Tarapore I) was a milestone in the external sector liberalisation process. The committee recommended a phased implementation of capital account convertibility over a three-year period: Phase I (1997–98), Phase II (1998–99) and Phase III (1999–2000). The committee suggested that the implementation of measures contemplated for each phase should be based on meeting certain preconditions. The recommended preconditions aimed generally at creating a stronger and healthier financial system with fewer controls. These included:

- Fiscal consolidation in the form of a gradual reduction in the centre's gross fiscal deficit to GDP ratio to 3.5 per cent in 1999–2000, accompanied by a reduction in the states' deficit as also a reduction in the quasi-fiscal deficit.
- Limiting the inflation rate for the three-year period at an average of 3–5 per cent; the Reserve Bank should have full independence to achieve the inflation rate mandated by Parliament.
- Consolidation of the financial system with full deregulation of interest rates in 1997–98, a gradual reduction in the average effective cash reserve ratio (CRR) to 3 per cent in 1999–2000, and reduction in gross non-performing assets (NPAs) of banks to 5 per cent in 1999–2000 and strengthening of the financial system.
- To design external sector policies to ensure a rising trend in the current receipts to GDP ratio from the present level of 15 per cent as well as to reduce the debt service ratio to 20 per cent (from around 23 per cent in 1996–97), and to prepare the financial system for capital account convertibility.

While commenting on the implementation of these recommendations, Tarapore II in 2006, discussed later in the chapter, stated that

> by and large RBI has taken action on a number of recommendations but the extent of implementation has been somewhat muted on some of the proposed measures (e.g., outflows by resident individuals and overseas borrowing by banks), while for some other measures, RBI has proceeded far beyond the Committee's recommendations (e.g. outflows by resident corporates). RBI has, however, taken a number of additional measures outside the 1997 Committee's recommendations.

At the instance of Prime Minister Manmohan Singh, a second committee on capital account convertibility was instituted, again under the chairmanship of Tarapore, in March 2006. The committee is commonly known as the one on 'Fuller Capital Account Convertibility' (Tarapore II). It submitted its report on 31 July 2006. The committee again recommended a phased implementation of capital account convertibility, as discussed later in the chapter.

While the Sodhani Committee set the agenda, Tarapore I and II drew the road map. In addition, the Reserve Bank appointed several committees, internal working groups and task forces to work out the process of reform of specific rules and regulations. These included the Committee on Procedures and Performance Audit on Public Services (CPPAPS) (2004), the Internal Technical Group on Forex Markets (2005) and the Internal Working Group on Currency Futures (2007). The first of these was set up, again, under the chairmanship of Tarapore. One of these committees recommended procedural liberalisation in forex services for residents to provide 'seamless flow of services' and to 'move away from micromanagement of controlling forex transactions, particularly for individuals'. The committee recommended several steps leading to the speedier release of forex at the branch level.[3] Residents could maintain foreign currency account outside India within the aggregate limit. NRIs were allowed easier remittance. The committee recommended changing the name of the Exchange Control Department to Foreign Exchange Department and urged a change in the attitude of bank officers from controllers to facilitators. The Internal Technical Group on Forex Markets examined options for further liberalisation. The group suggested several ways to expand the forex market.[4]

Since remittances from NRIs were a significant component of the country's forex inflows, a working group (April 2006) examined the cost of remittances.[5] Expatriates wishing to send small amounts back home to their families bore excessive costs. The group recommended, among other steps, that NRIs should route their remittances through Indian bank branches, and that the banks in India should view the remittances as volume-generating business and reduce the fees. Accordingly, the existing restrictions on the number of tie-ups with exchange houses and the number of drawee branches for rupee-drawing arrangements were to end. Banks were also advised to review the charges and adopt the latest technology for remittances.

The Task Force (Chairperson: Shyamala Gopinath, Deputy Governor) on rationalisation and simplification of forex regulations, constituted internally by Reserve Bank in the latter half of 2006, also made a contribution. The aim was to identify anomalies in the present regulatory framework. Its recommendations covered resident and non-resident corporates and individuals as well as financial institutions. Almost all the policies relating to the forex market and capital account liberalisation introduced during 2007-08 had their roots in the recommendations of the Task Force.

Earlier, the R.V. Gupta Committee on Hedging through International Commodity Exchanges (1997) and a working group (1999) to look into the system of reconciliation of Nostro accounts (account held in a foreign country by a domestic bank) in public sector banks had made significant contributions to liberalisation of the forex market.

In April 2008, an internal working group chaired by the Chief General Manager, Foreign Exchange Department, recommended the introduction of currency futures as an additional hedging tool, and proposed that, for introduction of USD–INR futures, contract size, tenor, design and settlement of contracts, among other issues, should be considered. The report also dealt with central clearing, 'margining' (facility given to traders to transfer margins from one account to another), and efficient surveillance and monitoring.

Besides committee reports, feedback received in the annual conferences led to procedural changes. These conferences were conducted by the Foreign Exchange Department, together with its regional offices and ADs. On the part of the Reserve Bank, bringing the officers of its regional offices and representatives of concerned ADs face to face was a useful learning experience. So was the system of periodic internal inspection, especially on procedural matters.

Following the Sodhani Committee report, in April 1996, a Foreign Exchange Market Technical Advisory Committee was set up. The committee recommended that the ADs should be free to fix their own aggregate gap limits. In January 1997, ADs were allowed to use derivative products, such as interest rate swaps, currency swaps and forward rate agreements, to hedge their asset–liability portfolio, which was expected to impart liquidity to the swap market and to ensure better management of foreign currency assets and liabilities by banks. While these steps were being taken, the Southeast Asian crisis broke out.

The August 1997 crisis raised doubts about the continuity of the liberalisation process. The Reserve Bank, however, accepted the recommendations of Tarapore I and decided in October 1997 to implement a number of measures relating to the liberalisation of capital transactions.

Again, in November 1997, when the forex market came under pressure, the Bank took several administrative measures to discourage arbitrage between domestic and foreign money markets. The reversal interrupted the process of market reform, but only temporarily. By mid-January 1998, as markets calmed down, the liberalisation exercise resumed.

These measures related to corporates, individuals and financial institutions. Individuals can be further disaggregated into residents and non-residents. Irrespective of the group, liberalising inflow was prioritised over outflows, though outflows related to inflows were somewhat relaxed, and equity flows were preferred to debt-creating ones.

Companies

In October 1997, to provide flexibility to meet their cash flow, exporters were permitted to retain up to 50 per cent of receipts in their foreign currency accounts with banks in India. In August 1998, streamlining the procedure, external commercial borrowing (ECB) guidelines were relaxed.[6] To encourage inward investment, from 12 October 1999, permission was granted to Indian companies to issue rights or bonus shares to non-residents and to send such shares out of India. Subsequently, they were also allowed to issue non-convertible bonds. Two-way fungibility in American depository receipts (ADRs) and global depository receipts (GDRs) issued by Indian companies was introduced in March 2001.[7] In January 2001, general permission was granted to Securities and Exchange Board of India (SEBI)–registered foreign venture capital investors to invest in Indian venture capital undertaking or in a venture capital fund.

The first major episode of misuse of liberalisation in capital accounts came to light in 2001. In mid-2001, SEBI reported that certain overseas corporate bodies (OCBs), though poorly capitalised, had remitted large amounts out of India. An OCB is usually a firm owned to the extent of at least 60 per cent by NRIs. Reserve Bank investigations also revealed that the accounts of OCBs were not operated within the parameters laid down under the Portfolio Investment Scheme. The issue of OCBs was again discussed by the High-Level Coordination Committee on Financial and Capital Markets (HLCCFCM) in August 2001, and by a Joint Parliamentary Committee on the stock market scam involving Ketan Parekh in December 2002.[8] Already in November 2001, it had been decided that OCBs would not be permitted to invest under the Portfolio Investment Scheme in India. A particular problem was that of tracing their addresses. Some of the letters issued during the survey conducted by the Bank were returned as the respective companies were not found at the addresses they had furnished.

To allow corporates to have a wider choice of external borrowing, they were allowed, in March 2002, to issue foreign currency convertible bonds up to US$50 million per year. As capital flows turned buoyant, the period of realisation of exports was allowed to be beyond six months where the invoice value did not exceed US$100,000 (January 2002). All forex earners were allowed to credit 100 per cent of their earnings to their exchange earners' foreign currency (EEFC) accounts. Companies were allowed to retain commercial borrowings in bank accounts abroad (January 2003). In February 2003, resident shareholders of Indian companies, who offered their shares for conversion of ADRs, were allowed to receive the sale proceeds in foreign currency, subject to the approval of the Foreign Investment Promotion Board (FIPB). Further, the sale proceeds so received were also permitted to be credited to their EEFC/resident foreign currency (domestic), or RFC(D), accounts.

In January 2004, ECB guidelines were revised to make the procedure more transparent. ECBs were permitted to be raised for investment in the real sector, the industrial sector and especially the infrastructure sector.[9] In October 2004, conversion of such borrowings into equity was allowed. Permission was also granted for the transfer of shares, increase in foreign equity participation by fresh issue of shares, and conversion of preference shares into equity capital.

Outflows were further liberalised during the latter part of the period. After the onset of the Southeast Asian crisis, some monetary and administrative measures were taken to discourage outflows (also see Chapter 3). As the crisis subsided, the Reserve Bank took steps to remove the restrictions on outflow transactions.[10] In December 1998, many forex provisions for outflow were eased. The yearly ceiling for clearance of proposals for investment abroad by an Indian company was raised from US$4 million to US$15 million. The Bank decided to grant blanket approval to Indian companies for investment abroad in the field of software.[11] In April 1999, Indian entities were permitted to open, hold and maintain a foreign currency account with a bank outside India in the name of its office or branch set up outside India.

A significant amount of ECB was contracted at a fixed interest rate. When international interest rates began to fall in the late 1990s, the Reserve Bank permitted (September 1999) prepayment of loans up to US$100 million, enabling companies to take advantage of low international interest rates. The limit was gradually raised to reach US$400 million by April 2007.

In March 2001, the Reserve Bank allowed Indian companies wishing to acquire foreign companies or make direct investment abroad in joint ventures or wholly owned subsidiaries to invest up to US$50 million annually through the automatic route, and invest up to 100 per cent of the proceeds of depository receipts issued for acquisition of foreign companies and direct investments. The ban on overseas investments by registered partnership firms was removed.

Indian direct investment abroad was allowed under two conduits – fast-track (automatic route) and normal route. The former had limits that were raised from time to time. A committee assessed the twofold division and recommended increasing the limit under automatic route from US$15 million to US$50 million.[12] The Reserve Bank would process all proposals above US$50 million under the normal route. On 3 September 2002, the amounts were revised further upwards. The decision process in the committee was often slow, however (see Appendix A4.1).[13] Although the committee remained with the Bank, the meetings became few and far between as most aspects of Indian investment abroad were liberalised.

As capital inflows picked up from 2001–02, liberalisation of outflows was construed as one of the ways in which the problem of excess capital flows could be handled. In November 2002, the limit for advance remittance without bank guarantee by ADs was raised for import of goods into India.[14] In July 2003, all companies entering into foreign technology collaboration agreements under the automatic route, irrespective of the extent of foreign equity in the shareholding, were permitted to make royalty payment at 8 per cent on export and 5 per cent on domestic sales without any restriction on duration of royalty payments. In March 2005, the ceiling of investment by Indian entities in overseas joint ventures and/or wholly owned subsidiaries was raised from 100 per cent to 200 per cent of their net worth under the automatic route.[15]

Although foreign institutional investors, or FIIs, were allowed to invest in the equity market with some restrictions, they did not have access to the debt market. There was a long-standing demand that they be allowed to participate in the debt market. On 8 March 1997, FIIs were permitted to invest in dated government securities. From June 1998, ADs could provide forward cover facilities for FIIs with respect to their fresh investments in equity. In August 1998, limits for investments by OCBs, FIIs and NRIs in Indian companies were enhanced, and ceiling applicable to individual NRIs and OCBs with respect to their portfolio investment in shares/debentures of an Indian company was raised from 1 per cent to 5 per cent of the paid-up equity capital of the company concerned. In April 1999, the limit of the aggregate ceiling of FII investment was raised from 30 per cent to 40 per cent of issued and paid-up capital of an Indian company.

The government securities market and the corporate bond market were opened to FIIs in a more measured way. They were allowed to invest in long-term securities in March 1997, and in treasury bills (T-bills) in June 1998.[16] In February 2004, multilateral development banks, such as the International Finance Corporation (IFC) and the Asian Development Bank (ADB), which were specifically permitted by the central government to float rupee bonds in India, could purchase dated government securities.

Non-residents

The Reserve Bank introduced a new type of account, the non-resident special rupee (NRSR) account, in April 1999 for NRIs who would voluntarily undertake not to seek repatriation of funds held in such accounts.[17] In November 1999, general permission was granted to Indian mutual funds to issue units or similar instruments under schemes approved by SEBI to FIIs with repatriation benefits, subject to certain conditions. To enhance FII participation, they were allowed to invest up to 49 per cent in an Indian company under the portfolio investment route with the approval of the company's general body of shareholders from March 2001. Deregulation of interest rates on non-resident accounts has been discussed in Chapter 3 and does not require further discussion here.

Liberalising outflows further, in July 2002, ADs could repatriate funds out of balances held by NRIs and persons of Indian origin (PIOs) in their non-resident ordinary rupee (NRO) accounts for certain purposes.[18] To avoid asset–liability mismatches and meet risk management guidelines, banks were permitted to invest their foreign currency non-resident (banks) (FCNR[B]) deposits in longer-term fixed-income instruments, provided these instruments had an appropriate rating. In September 2002, Indian branches of ADs were permitted to grant foreign currency loans in India, against the security of funds held in their FCNR(B) deposit accounts, to the account holders only. The following year, ADs were allowed remittance up to US$1 million in a calendar year out of the balances held in NRO accounts or from sale proceeds of assets. In February 2004, ADs were permitted to grant rupee loans to NRIs, other than for specified prohibited purposes.[19]

The CPPAPS had recommended that the power-of-attorney holder in non-resident accounts should be allowed to remit money outside India as he or she was permitted to execute domestic transactions. The recommendation was accepted in November 2004, and extended to NRO accounts in 2007. The concern raised by the Legal Department that this might lead to money laundering was rejected because the onus to prove the genuineness of the transaction remained with the NRI concerned. Further, the Reserve Bank clarified to banks that NRO accounts could be held by non-residents jointly with residents. In 2007, ADs were allowed to remit the maturity proceeds of FCNR(B) deposits to third parties outside India.

Residents

Residents were subjected to more restrictions. These were liberalised step by step. In May 1997, residents could take interest-free loans from NRIs for personal purposes or for carrying on business activities on repatriation basis under the automatic approval route, subject to certain conditions. In March 1998, general permission was granted to resident individuals and proprietorship concerns for raising non-repatriable rupee loans from NRIs. From September 1998, residents could use facilities against the collateral of fixed deposits in NR(E)R accounts.[20]

In November 2001, a ceiling of US$500, allowed to those travelling to countries other than Iraq, Libya, Iran, Russia and the Commonwealth of Independent States, was raised to US$2,000 or its equivalent, without prior permission from the Reserve Bank. In September 2002, to make the release of forex to resident individuals easier, ADs were permitted to release an amount up to US$500 for all permissible transactions on the basis of a simple letter from the applicant. There was still a limit of US$5,000 to be released by ADs to resident individuals in one calendar year for travel; this was enhanced to US$10,000 in 2002. Residents were also allowed to hold US$2,000 in cash or in an RFC(D) account.[21]

These steps, taken in quick succession, did not always follow a predetermined script. The emergence of a virtuous circle between inflow and outflow influenced the reform process. There was always more regulation upon outflow. But there was also the force of an argument that reducing restrictions on outflows was a precondition for more inflow to occur. When inflows did pick up in the early 2000s, further liberalisation of outflows became possible, as the country had enough reserves to meet the unforeseen scale of repatriation. Indeed, higher outflows could then be a way to handle excess capital inflows, or as a stabilisation measure.

In January 2003, the limit for advance remittance for import of services by ADs without the prior approval of the Reserve Bank was raised by a large margin. Resident individuals were permitted to invest abroad in companies.[22] In July 2003, the limits on remittances for specific purposes like education, employment, or maintenance of close relatives were substantially and uniformly enhanced.[23] In December 2003, the limit for forex remittance by resident individuals for miscellaneous current transactions other than imports was raised and did not need documentation.[24]

More controversially, Indian students studying abroad were treated as NRIs and eligible for all the facilities available to NRIs. By international norm, students studying abroad were treated as residents. The Reserve Bank made a deviation. A press release dated 8 December 2003 stated that

> the purport of their [Indian students abroad] argument is that though they are students, they are, in reality, not dependent for a dominant part of their expenses on remittances from their households in India. Often they are permitted to work and have to undertake certain related financial transactions. They urge, therefore, that the definition needs to be revised.

This argument was accepted, even though in the balance of payments accounting, students studying abroad continued to be treated as residents.

There is an interesting backdrop to the change of residential status of students. A Board member of the Reserve Bank had written to Governor Jalan (1 April 2003) that his son, then studying in the United States (US), ought to be considered as a non-resident. His tax attorney, he said, supported the claim. The response from the Reserve Bank Legal Department was initially negative. However, after much deliberations, the Legal Department responded by saying that without prejudice to the interpretation of NRI under FEMA, some of the facilities extended to NRIs, like opening foreign currency deposits with banks in India, could be extended to students by making necessary amendments to the deposit regulation of the FEMA. Concurrently, the Reserve Bank had taken up the matter with the Government of India. The government convened a meeting, following which the deposit regulation of FEMA was amended, allowing students studying abroad to open NRI deposits. Eventually, the residential status of Indian students was changed and a circular was issued on 8 December 2003.

Who Is a Non-resident Indian?

There were two definitions of an NRI, one set out by FEMA and the other by the Income Tax Act, 1961. FEMA contains a clause (Section 2[V]c) that says that a person going abroad with an intention of staying there for an uncertain period would become a non-resident. This clause was absent in the Income Tax Act. The implication of the FEMA clause was that persons going abroad with an intention of staying for a definite period, like students, business visitors and tourists, would be treated as residents. This anomaly made the case of students, like the one just mentioned, open to legal disputation.

Not only with students but in several other contexts too, the Reserve Bank needed to engage with the interpretation of residents and non-residents. One of these was the acquisition and transfer of immovable properties. FERA provisions had laid down that only Indian nationals could acquire immovable property in India. Under FEMA, the eligibility criteria were based on residential status rather than nationality. An NRI or a foreign national living in India on employment, business, or any other purpose for an uncertain period, and who was thus a resident, could acquire immovable property in India. The only exception was made for those from Pakistan, Bangladesh, Sri Lanka, China, Iran, Afghanistan, Nepal and Bhutan.[25] A few foreign nationals on long visa acquired immovable property, particularly in Goa. When such cases were reported, the Reserve Bank advised the buyers to transfer the assets in favour of residents.

These cases revealed a further anomaly in the law. While the Registration Act was a state law, FEMA was the centre's responsibility. If the Government of India did not want these acquisitions to happen, it should have instructed the states to follow the provisions of FEMA. In any case, because such cases were frequent in Goa, the Reserve Bank regional office in Panaji held a meeting with the sub-registrars in the state on 19 February 2005. The registrars held that they were required to apply only those laws at the time of registration that were made supplemental to the Registration Act, 1908, and FEMA was not one of them. Further, it was found that some registrars' offices in Goa refused to register sale deeds without the Bank's clearance regarding the residential status of foreigners. Against this backdrop, the Bank wrote to U. K. Sinha, Joint Secretary, Ministry of Finance (14 January 2005), stating,

> As residential status of a person in India in terms of Section 2(V) of FEMA is dependent both on specific parameters like length of stay and intention of the concerned person, it was impractical for RBI to try to determine residential status of a person.… [I]n view of the foregoing, we request you to take up the matter for such action deemed necessary, with the State Government of Goa, as well as other Administrative Ministries.

In the meantime, a few of these cases were referred to the Enforcement Directorate. A few media reports appeared and questions were asked in Parliament about flouting of the FEMA by foreign nationals.[26]

In another incident, a resident of Delhi filed a petition on 22 August 2003 with the Committee on Petitions, Rajya Sabha, stating that foreign nationals from neighbouring countries, though staying in India for long and holding ration cards, were not allowed to purchase residential flats from government agencies like the Delhi Development Authority. The case was referred to the Reserve Bank for their view by the Ministry of Finance. The Bank wrote (21 September 2003) that the policy of the government did not permit such investment. Complaints received by the Bank showed that there were, in fact, many such cases of illegal acquisition of immovable properties by nationals of the 'de-listed' countries. There were also curbs on NRIs transferring agricultural and plantation property and farmhouses. It was a subject of discussion between the Bank's central office and its Kochi regional office in August 2004. The matter was 'resolved', if that is the right expression, with the statement that 'the applicant may be advised to take up the matter with the Ministry of Finance' as it was the policy of Government of India.

There was yet another inconsistency. All Indian residents were outside the purview of FEMA for the purchase of immovable property in India. They were also allowed transfer of any immovable property in India from NRIs (who were citizens of India, Regulation 3[b] of FEMA 21/2000). However, this made it technically possible for a foreign national, treated as a resident, to acquire agricultural and plantation property from an NRI, which was not intended.

Similar confusion arose when the Intelligence Bureau (IB), Ministry of Home Affairs, wrote a letter to the Ministry of Finance on 10 August 2006 which, in turn, was referred to the Reserve Bank. The letter drew attention to the discrepancy in the definition of NRI in FEMA, which equated NRIs with persons of Indian origin, or PIOs, and overseas citizens of India (OCIs). According to the letter, three distinct clauses within FEMA were not mutually consistent in the treatment of PIOs. In two of these, an NRI was defined as a 'person resident outside India who was a citizen of India or a person of Indian origin', whereas the third stated that an 'NRI was a person resident outside India who was a citizen of India'. 'Our concern,' the letter went, 'is that PIO cannot be equated with NRI, as NRI is an Indian citizen who stays abroad for employment, business, vocation or any other purpose, whereas PIO is a foreign national, though of Indian origin.'

The Reserve Bank, after consultation with its Legal Department, replied on 2 March 2007 that the regulation, which dealt with remittance of assets, did not include PIOs as the intention was to dissuade citizens of certain countries acquiring immovable property in India. For most other transactions, the two sets could be treated equally. It was not necessary, therefore, 'to address the issue of difference in the definitions of NRI and PIO in the notifications issued under FEMA as suggested by IB'.[27]

In the process that led to FEMA, this definitional issue had been discussed and left somewhat unclear. The Reserve Bank originally suggested in its draft FEMA Bill sent to the Government of India in 1997 that 'persons resident in India' meant an individual residing in India, including citizen of India undergoing any training or study abroad, but did not include a tourist or visitor from outside India visiting for a period not exceeding 180 days, nor include a foreign national residing in India for a specified period not exceeding five years and for a specific purpose. But the FEMA Bill tabled in Parliament (August 1998) carried the definition of 'persons resident in India' as a person residing in India for more than 182 days during a 365-day period. The Parliamentary Standing Committee on Finance, to which the 1998 Bill was referred, did not agree to change the definition of residents in FEMA. As this recommendation of the standing committee was not acceptable in its entirety, several rounds of meetings and discussions took place between the government and the Bank, the outcome of which was the present definition of residents, which gave rise to interpretational issues. As far as one can see, there was no subsequent attempt to simplify the definition of residents during the reference period of this volume.

Financial institutions

In April 1997, ADs were permitted to borrow from their overseas offices and correspondents as well as invest up to US$10 million in overseas money market instruments, which was essentially intended to augment banks' resources and strengthen integration between overseas and domestic money markets. The limit was increased in October 1997 up to a maximum extent of 15 per cent of their unimpaired Tier I capital.[28] In April 2002, the limit was again raised to 25 per cent of unimpaired Tier I capital.[29] A further increase in the limit was announced in November 2002, and in December the same year the limit was removed completely. In March 2004, to rationalise the existing facilities for overseas borrowings and introduce a monitoring and reporting system for all ADs, existing facilities available to them were replaced by a single facility.[30]

In April 1997, ADs had been allowed to arrange forex–rupee swaps between corporates and run a swap book within their open positions or gap limits without the approval of the Reserve Bank. The Bank allowed branches of foreign companies operating in India to remit profits to their head offices through ADs without the Bank's approval. To make the pricing of rupee interest rate derivatives more flexible, interest rates implied in the forex forward market were allowed to be used as a benchmark in addition to the existing domestic money and debt market rates.[31]

In November 2004, ADs were granted general permission to issue guarantees, letters of comfort, and letters of undertaking in favour of overseas suppliers' banks for their importer clients.[32] In July 2005, ADs were allowed not to follow up submission of evidence of import involving an amount of US$100,000 or less if they were satisfied with the genuineness of the transaction and the bona fide purpose of the remitter. Banks' Board of Directors would frame a suitable internal guideline. Banks could approve proposals for commodity hedging in international exchanges from their corporate customers. In February 2006, banks and authorised money changers were advised to take necessary steps to ensure compliance with the rules under Prevention of Money Laundering Act, 2002. The guidelines required asset management companies to put in place a policy framework on 'know your customer' and 'anti-money laundering' measures for the prevention of money laundering while undertaking money changing transactions.

As the external sector liberalisation progressed, the number of customers undertaking forex transactions rose exponentially. More and diverse entities could handle non-trade current account transactions. Select 'full-fledged money changers', urban cooperative banks and the regional rural banks were permitted to release and remit forex for specified types of current account transactions. The regulations relating to insurance companies were liberalised.[33]

Liberalisation of investment by mutual funds in overseas markets experienced a bumpy road. As part of the implementation of the recommendations of Tarapore I, Governor Rangarajan, on 21 October 1997, announced in his monetary policy statement that Indian funds registered with SEBI, including mutual funds, would be allowed to invest in the overseas markets.[34] The committee set up by SEBI to work out the details of the process submitted its report in July 1998. In the meantime, the High-Level Committee on Capital Market discussed the issue in August 1998 and recommended that mutual funds' investment abroad be restricted for the time being to investments in the ADRs or GDRs of Indian companies only. Within the Reserve Bank, there was some hesitation about this move.[35]

Finance Secretary Vijay Kelkar wrote on 21 May 1999 to Governor Jalan that the Finance Minister approved the mutual funds' overseas investment in depository receipts. Necessary guidelines on limits to such investments and procedural aspects were issued on 30 September 1999 after a group of officers from the Reserve Bank and SEBI worked out the details of the regulation.

In November 1999, SEBI requested the Reserve Bank to consider an extension of the facility to securities other than depository receipts. Governor Jalan agreed.[36] The Bank issued a circular on 13 January 2003 allowing mutual funds (and corporates and individuals) to invest in the equity of listed foreign companies having at least 10 per cent stake in Indian companies. In May 2003, the Bank decided to henceforth give only general permission.[37]

In June 2004, an internal study analysed the progress of the scheme and observed that as of end of March 2004, out of the seventeen mutual funds that had taken approval from SEBI, only four had made investments of a total of US$23.12 million. The reason for the poor performance of the scheme was that the condition that mutual funds could invest in the equities of only those foreign companies that had 10 per cent stake in Indian companies was too restrictive. The Reserve Bank in its Budget proposal for 2006–07 sent to the government recommended its removal. Finance Minister P. Chidambaram rescinded this clause and increased the overall limit.[38]

Legal and Institutional Framework

The repeal and replacement of FERA with FEMA have been mentioned on a number of occasions before. During the latter part of 1997, there was an attempt to introduce the FEMA Bill in Parliament but opposition to the Bill, especially from Left parties, disrupted the process. Eventually, FEMA Bill, 1998, along with the Prevention of Money-Laundering Bill, 1998, was introduced in the 12th Lok Sabha on 4 August 1998.[39] While the FEMA was passed, the Prevention of Money Laundering Bill was referred to the Select Committee of the Rajya Sabha on 8 December 1999. FEMA became effective 1 June 2000, and the Prevention of Money Laundering Act was enacted in January 2003.[40]

FEMA was not merely an amendment of FERA. It reflected a different approach, a shift from 'control' to 'management'. FEMA was built around the main theme of dismantling controls and affording an enabling condition for all stakeholders in forex transactions. The main tenets of FEMA were transparency, transaction monitoring and data dissemination. Unlike FERA, which treated any violation or contravention of the provision of the Act as a criminal offence, FEMA treated these as civil offences. FEMA drew a clear line of demarcation between the current and capital accounts. All current account payments, except those notified by the government, were eligible for appropriate foreign currency release from ADs. The Reserve Bank was empowered with the necessary regulatory jurisdiction over capital account transactions. FEMA thus formalised current account convertibility with the common law principle of 'all that is not forbidden is permitted', but left the capital account still subjected to the rule of 'all that is not permitted is forbidden'. It provided for an elaborate redressal process with separate administrative procedure and mechanism in the form of compounding rules, adjudicating authority, Special Director (Appeals) and Appellate Tribunal, with a stipulated time frame for each leg of the judicial process.

The concept of 'compounding' was another distinguishing feature of FEMA, especially from the perspective of customers. Under FERA, all violations were subject to separate investigation and adjudication of the Enforcement Directorate. It was next to impossible to track all the offences, especially those that were of small order. Only when contraventions were detected were offenders brought to book. Under FEMA, the redressal mechanism was changed to give the supposed offender a chance to make an application suo moto, seeking the contravention to be compounded.

Contravention could be compounded only if the amount involved was quantifiable. The intent was to reduce transaction costs and at the same time deal with fraudulent transactions severely. No request for compounding of contraventions would be entertained for earlier violations after a contravener was found guilty of violating FEMA provisions. The compounding authority was required under the Act to dispose of the application within 180 days in the normal course. Once a contravention was compounded, no proceeding or further proceeding could be initiated or continued, as the case may be.

Although the compounding rules delegated the authority of compounding to the Reserve Bank, the actual transfer of work relating to compounding from the Enforcement Directorare to the Bank took place only on 1 February 2005. The initial notifications in this regard had given incomplete power to the Bank. A revised notification on 13 September 2004 delegated to the Bank the entire power of compounding, except cases dealing with informal *hawala* transactions,[41] which were retained with the Enforcement Directorate. Soon after the move, the Bank issued the necessary directions to operationalise the scheme.[42] To begin with, the compounding task was handled at the central office of the Foreign Exchange Department, Mumbai, and subsequently delegated to select regional offices after holding several rounds of interactive sessions, workshops and seminars with all stakeholders.

The delegation of powers by the Reserve Bank to ADs to release forex constituted a major improvement to the institutional framework. Along with specific measures, there was also an effort to change the administrative work culture. To ensure such seamless change, the Foreign Exchange Department's central office conducted several workshops, seminars and discussions in all regional offices of the Bank to educate staff, corporates and important customers. These discussions highlighted the distinctive approach embodied by FEMA (also see Box 4.2).

A high-level coordinating committee was in place to address the common issues that different regulators of the capital market faced. The secretariat was in the Reserve Bank. The committee was initially called the High-Level Committee on Capital Market and had members from the Bank, SEBI and the Ministry of Finance. Subsequently, in the early 2000s, the committee was called the High-Level Coordination Committee on Financial and Capital Markets and added the Insurance Regulatory and Development Authority of India (IRDAI) as a member. All issues, including major liberalisation measures, were first deliberated in the committee.

Box 4.2 Broad Comparison of FERA and FEMA

Foreign Exchange Regulation Act (FERA)	*Foreign Exchange Management Act (FEMA)*
FERA came into force with effect from 1 January 1974.	FEMA replaced FERA with effect from 1 June 2000.
The main objective was 'foreign exchange control' by conserving the forex resources of the country and utilising them properly.	The major objective is to 'facilitate external trade and payments, and to promote orderly development and maintenance of forex market'.
Violation of the provisions was a criminal offence.	FEMA is a civil law and contravention of its provision is only liable for monetary penalty and dealt with through civil procedures.
Offences were not compoundable and all violations were subject to separate investigation and adjudication of the Enforcement Directorate. The burden of proof was on the implicated.	A contravener has an opportunity to make an application suo moto to the compounding authority requesting for compounding the contraventions. The burden of proof is on the enforcement agency. FEMA provides for an elaborate process with separate administrative procedure and mechanism in the form of compounding rules, adjudicating authority, Special Director (Appeals) and Appellate Tribunal, with a stipulated time frame for each leg of the judicial process.
Carried the principle of 'all that is not permitted is forbidden'.	FEMA formalises current account convertibility with the common law principle of 'all that is not forbidden is permitted' but leaves the capital account unchanged – 'all that is not permitted is forbidden' – as India does not have full capital account convertibility.
Citizenship/nationality was the criteria to determine the residential status of a person.	'Person resident in India' means a person residing in India for more than 182 days during the course of the preceding financial year, excluding such person as who stays outside India on employment, business, or vocation or who indicates his intention to stay outside India for an uncertain period. By the same token,

(*Contd.*)

(*Contd.*)

Foreign Exchange Regulation Act (FERA)	*Foreign Exchange Management Act (FEMA)*
	non-residents who have come to stay in India on employment, business, or vocation or who indicate their intention to stay in India for an uncertain period are treated as residents.
FERA was applicable to all citizens of India outside India.	Unlike FERA, FEMA does not apply to Indian citizens resident outside India.

A Mumbai Interbank Forward Offered Rate (MIFOR) swap curve evolved in 2000 gave impetus to market development. The CCIL launched a Forex Trading Platform to facilitate US Dollar/Rupee deals by banks in India. The Clearing Corporation of India Ltd (CCIL) brought the entire range of forex transactions under its scope. In 2004, the ambit of the Technical Advisory Committee on Money and Government Securities Markets set up by the Reserve Bank was expanded to include the forex market and was renamed as the Technical Advisory Committee on Money, Securities, and Foreign Exchange Markets. On-site and off-site monitoring mechanisms were strengthened to build a robust management information system.[43] Closing time for the interbank forex market was extended up to 5 p.m. in May 2005. In October 2006, the Reserve Bank of India (RBI) Act was amended to define the regulatory purview of the Bank over derivatives.

Hedging and Its Instruments

The evolution of the forward market and hedging instruments in India can be documented by tracing the developments under different segments of market players – residents, non-residents and financial institutions, particularly banks.

For all practical purposes, the history of the forward market in India began in 1992 when residents were allowed to enter into a forward contract with ADs to hedge their exchange risk of buying or selling forex for approved transactions. In September 1996, residents in India were permitted with certain conditions to enter into a foreign currency option contract with ADs in India to hedge forex exposure arising out of their trade, and cross-currency options were only allowed to be written on a fully covered back-to-back basis. In April 1997, the scope of the forward cover mechanism was expanded to include residents, with forex or rupee liability, who could enter into a contract for a foreign currency–rupee swap with ADs in India to hedge long-term exposure under certain terms and conditions.

In October 1997, more instruments of hedging were added. Residents with foreign currency borrowing were permitted to enter into an interest rate swap, currency swap, coupon swap, foreign currency option, interest rate cap or collar (purchases), or forward rate agreement (FRA) contract with an AD in India or with a branch outside India of an AD for hedging loan exposure and unwinding such hedges. It was stipulated that the contract should not involve the rupee, and also that the maturity of the hedge should not exceed the unexpired maturity of the underlying loan, besides other conditions.

Export growth during 1996–97 in US dollar terms had contracted. There was no hedging mechanism available for exporters or importers. Against this backdrop, the Reserve Bank appointed (July 1997) a committee on Hedging through International Commodity Exchanges.[44] The committee recommended that all Indian entities with genuine underlying commodity price risk exposures should be permitted recourse to hedge instruments available in offshore markets, subject to safeguards. In September 1998, the Bank permitted hedging in international commodity markets.

A further series of measures was introduced in 2003. In April, ADs were permitted to enter into forward contracts with residents with respect to transactions denominated in foreign currency but settled in rupees, with the condition that these contracts should be held until maturity and cash settlement would be made on the maturity date by the cancellation of the contracts. In July 2003, foreign currency–rupee options were introduced. ADs were permitted to offer the product on a back-to-back basis or run an option book as per the specified terms and conditions. In December 2003, residents with overseas direct investments (ODIs) were permitted to hedge the exposure under certain terms and conditions. In November 2004, the limit for outstanding forward contracts booked by importers/exporters was increased from 50 per cent to 100 per cent of their eligible limit. In June 2005, cancellation and rebooking of all eligible forward contracts booked by residents, irrespective of the tenor, were allowed, subject to certain conditions.

In April 2007, domestic entities were allowed to hedge their price risk on aluminium, copper, lead, nickel and zinc, as well as users of aviation turbine fuel in international commodity exchanges, based on their underlying economic exposures. The Reserve Bank also decided to consider requests for those not covered above. The stipulation that forward contracts booked by exporters and importers in excess of 50 per cent of the eligible limits should be on deliverable basis and could not be cancelled was relaxed by extending the limit to 75 per cent. Residents with ODI and small and medium-sized enterprises (SMEs) were provided more flexibility to cancel and rebook forward contracts. In October 2007, to enable resident individuals to hedge their forex exposures arising out of actual or anticipated remittances, the Bank decided to permit them to book forward contracts without production of underlying documents, subject to a limit.[45]

The Reserve Bank had recognised the danger of expansion of off-balance-sheet forex exposure of banks, which had contributed to some of the banking crises before. Therefore, a cautious policy approach was followed in this regard. In April 1997, a beginning for rupee-based derivatives was made in India and banks were permitted to offer dollar–rupee swaps to corporates to actively manage their forex exposures. A major step was taken in June 1997, when ADs were permitted to use interest rate swaps, currency swaps and forward rate agreements to hedge their asset–liability portfolio.[46]

In October 2002, ADs were permitted to offer forward contracts to their constituents (exporters of gold products, jewellery manufacturers, trading houses, and so on). Another major decision taken in November 2002 was that foreign banks could hedge their entire Tier I capital in India held by them in Indian books as long as the capital funds were available in India to meet local regulatory and capital to risk-weighted asset ratio (CRAR) requirements.[47] In October 2003, ADs were delegated the power of offering forward cover for such investments. In October 2007, in order to enable ADs to manage their risks efficiently, they were permitted to run cross-currency options books, subject to the Reserve Bank's approval. As against the existing practice of allowing ADs to offer only 'plain vanilla' European options, they were permitted henceforth to offer American options as well, in keeping with the market demand and gradual evolution of the forex market.

Non-residents were generally not allowed to play in the forward market in India. However, a few facilities were extended to non-residents that were essential from the standpoint of facilitating the inflow of certain varieties of foreign capital.[48]

Reforms in Data Collection and Dissemination

In January 1999, a working group set up to look into the system of reconciliation of Nostro accounts in public sector banks suggested that banks should initiate measures for mechanisation of branches, immediate follow-up of large-value items, and training and re-training of the employees.[49] FEMA made a few procedures redundant. For example, persons resident in India were not required to submit annual returns with respect to all types of foreign assets held by them, either in terms of general permission or specific permission of the Reserve Bank.

The reform process could outpace data collection. At the time of exports, exporters were required to submit GR forms in duplicate.[50] The original was submitted to the customs and the duplicate to AD for negotiation. ADs were required to submit, on the realisation of export proceeds, the duplicate of different types of GR forms to the nearest office of the Reserve Bank. The Bank, in turn, would match the original GR form that was transmitted by the customs to the concerned regional office of the Bank. In September 2002, ADs were advised that, henceforth, such duplicate copies of the export declaration forms should not be submitted to the Bank. Instead, these should be retained by the ADs, who should carry out random checks to confirm that non-realisation or short-realisation cases, if any, were allowed by them or approved by the Bank. Thus, the GR-matching exercise for each transaction was in effect done away with. When an export scam involving iron ore broke out in 2010–11, the Bank was not in a position to assess the magnitude of unrealised exports under iron ore exports. The internal committee set up to study the episode in September 2012 observed that one of the reasons for non-matching of export data of the customs with that of the banking systems had been the non-submission of export documents to AD banks.

India was one of the first few countries to become a member (1996–97) of the International Monetary Fund's (IMF's) special data dissemination standards and general data dissemination standards, which required dissemination of a wide range of information. India started posting its metadata on the IMF's dissemination standards bulletin board on 30 October 1997. The Reserve Bank had achieved full disclosure of information pertaining to international reserves, foreign currency liquidity position, balance of payments and external debt as well as international investment position under the standards. Also, the Bank improved statistical coverage in its periodic publications such as the *Weekly Statistical Supplement*, the *Monthly Bulletin* and the *Annual Report*.

One such example was data on forex turnover. The Bank was periodically issuing instructions to its regulated entities regarding rules and regulations for conducting their business. In order to enable the regulated entities to have all the instructions at one place, a master circular consolidating and incorporating all currently operative instructions and guidelines on the subject was issued. These were a one-point reference of instructions issued by the Bank on a particular subject between July and June (the Bank's financial year), with a sunset clause.

Capital Account Management

Internationally, private capital flows had been increasing rapidly since the 1980s, surpassing official flows. To take advantage of the increased private flows, many emerging economies relaxed the restrictions on capital transactions to capture more of the flow. Until the Southeast Asian crisis in mid-1997, the received wisdom tilted towards more openness in this respect. The Organisation for Economic Co-operation and Development (OECD), for example, was trying to spread its 'Code of Capital Account Liberalisation, 1961' to jurisdictions beyond the OECD. The IMF advised its members to liberalise capital account. Since the IMF's Articles of Agreement had permitted the members to allow capital controls, it sought to amend its Articles to incorporate capital account convertibility as one of the obligations of the membership.

The Asian crisis brought the dangers of free capital movement to the fore. The international debate on the merits of capital account liberalisation turned out to be inconclusive.[51] The Reserve Bank had, in fact, raised concerns about the adverse consequences of unbridled cross-border capital flows well before the crisis. In his statement in the IMF's Interim Committee meeting in April 1997, Governor Rangarajan stated,

> [S]everal staff studies have shown that there are important preconditions for introducing capital account convertibility. Given the differences among countries with regard to progress made towards structural reform and stabilization, it may be unwise to put all the members in a straitjacket where they lose their independence to take corrective action in times of crisis.[52]

Despite the uncertain international economic environment, the liberalisation process was carried forward, but with caution.

The initial years of the reference period – up to the new millennium – saw several initiatives to ward off the negative effects of international developments. Some of these included elements of tightening control but those were announced as 'temporary' to gain market confidence, which were relaxed subsequently.

The year 1997–98 opened with enormous optimism emanating from an impressive performance of the Indian economy in 1996–97. The external sector, in particular, had fared well in 1996–97, adding almost US$6 billion to forex reserves buoyed up by a surge in capital flows. This trend continued until the first half of 1997–98. The Reserve Bank made a net purchase of foreign currency assets from the market to the tune of US$5.4 billion between April and August 1997. In the wake of the Asian crisis, the forex market came under pressure because of capital flows drying up. Deputy Governor Reddy's statement on 15 August 1997 and the subsequent statement by Prime Minister I. K. Gujral (reported in the *Economic Times* on 20 August 1997) on the exchange rate of the rupee added to the stress in the Indian forex market. The market became highly volatile – especially from November 1997 to January 1998 (see Chapter 5).[53] It also led to an increase in activity and expansion of the forex market. For example, interbank forex turnover as a percentage of GDP, which was 0.19 per cent in 1995–96 and 1996–97, went up to 0.26 per cent in 1997–98.

Liquidity management remained a primary engagement for Reserve Bank authorities. New monetary measures were introduced to control the arbitrage opportunities because of the difference between domestic interest rates and forward rates. The negative market sentiment due to the crisis and adverse domestic political developments made the rupee highly volatile. In November 1997, besides intervening in the forex market, the Bank announced a few monetary measures.[54] By the end of January 1998, capital flows resumed. The Reserve Bank could recoup forex reserves in the January–March quarter in 1998 more than what it had lost during October–December 1997. As capital inflows picked up from March 1998, some of the monetary policy measures initiated in the previous months were rolled back.[55]

During 1998–99, the reversal of the monetary policy measures announced in January 1998 continued. However, in May 1998, when the Pokhran nuclear test was conducted, economic sanctions were imposed on India, and fresh multilateral lending was suspended. Moody's, which had maintained India at the lowest slot of investment grade at Baa3, pushed Indian sovereign rating down on June 1998 by two notches to Ba2, which was second in the list of non-investment grade rating. As a result, FII inflows fell. Delayed recovery in Asia, together with crises in Russia and Latin America induced the Reserve Bank to announce a fresh package of measures on 20 August 1998, including the floating of Resurgent India Bonds (RIBs).[56] The RIBs were meant for NRIs and overseas corporate bodies and aimed at mobilising resources to deal with possible disruptions in capital flows, particularly debt flows, which were anticipated as India's sovereign ratings were downgraded to non-investment grade. The scheme opened on 5 August 1998 and closed on 24 August 1998, mobilising US$4.23 billion. The RIBs had a five-year tenor and were denominated in three currencies – the US dollar, the pound sterling and the Deutschmark. The US-dollar-denominated bonds carried an interest rate of 7.75 per cent and mobilised US$4 billion, while the pound sterling bonds were at 8 per cent interest rate and brought in the equivalent of US$180 million. The Deutschmark bonds fetched US$63 million at 6.25 per cent interest rate.

Emboldened by improvement in March 1999, policy rates were eased in April 1999. The border conflict at Kargil (from 3 May 1999 to 26 July 1999) caused several episodes of mismatch between forex demand and supply in May and August 1999, which were addressed with a mix of operations in forex and money markets, essentially by aligning interest rates so as to reduce arbitrage opportunities. By November 1999, capital flows returned to the Indian market enabling the Reserve Bank to ease monetary conditions. The Bank also withdrew the stipulation of a minimum interest rate of 20 per cent per annum on overdue export bills and the interest rate surcharge of 30 per cent on import finance imposed in January 1998. In between, Indian companies were permitted to issue rights/bonus shares and nonconvertible debentures to non-residents, while mutual funds were permitted to issue units to FIIs. Foreign corporates and high-net-worth individuals were permitted to invest in Indian markets through FIIs. Besides, ECB policies were substantially liberalised. More importantly, FDI in all sectors, except for a small negative list, was placed under the automatic route. Indian overseas investment was also liberalised. As a result, the Bank added a little over US$6.1 billion to its corpus of forex reserves during 1999–2000.

As external conditions were benign, the Reserve Bank remained in policy easing mode at the beginning of 2000–01. A package of measures was introduced with the lowering of policy rates in April 2000. However, in May

2000, oil import payments rose on the back of a rise in the international price of crude oil. In just two months (May and June), the Bank lost close to US$2 billion by way of market intervention. The Bank announced on 25 May 2000 an interest rate surcharge of 50 per cent of the lending rate on import finance on all non-essential imports. The Bank also committed to undertake sovereign debt service payments, if necessary. Forex requirements for import of crude oil by Indian Oil Corporation were met directly and through the market. An interest rate of 25 per cent was charged on delayed export receipts. ADs acting on behalf of FIIs could approach the Bank to procure forex at the prevailing market rate.

Between May and August 2000, demand for forex had outstripped supply, which was addressed by monetary and regulatory measures. As the market stabilised from November 2000 onwards, monetary measures were phased out during the last quarter of 2000–01 to return to the April 2000 position. The main policy initiative during 2000–01 to encourage and facilitate industry's access to external capital flows was to relax FDI policy so as to improve the climate for new investment. Similarly, policies for international offerings through depository receipts by Indian companies were liberalised. Indian corporates' access to ECBs as a window for resource mobilisation was considerably improved and procedures streamlined. These measures yielded results as reflected in the net capital flows of close to US$6 billion in excess of the current deficit that was added to the reserves in 2000–01.

Another major development in the year 2000 was the issuance of India Millennium Deposits (IMDs). Rising crude oil prices in the early 2000s eroded foreign currency assets of the Reserve Bank by around US$3 billion during April–October 2000. Sanctions were still in force (until August 2000). To bolster forex reserves and impart stability to India's balance of payments, the scheme was launched on 21 October 2000 with a tenor of five years. Denominated in three currencies – the US dollar, the pound sterling and the euro – the scheme carried an interest rate of 8.5 per cent, 7.85 per cent and 6.85 per cent, respectively, and mobilised US$5.5 billion. These bonds were not tradeable in the secondary market and not eligible for encashment prematurely. Both the RIBs and IMDs carried an exchange guarantee provided by the government to the borrowing bank, which was SBI.

The cost of borrowing for both schemes, however, was deemed to be high. In response to a Parliamentary question seeking information on cost and use of the schemes (RS No. 3422, answered on 7 April 2001) Minister of State (Ministry of Finance) Balasaheb Vikhe Patil stated that the interest rates were compatible with international rates in view of India's credit rating. The response also clarified that the funds were utilised for investment in government securities placed with participating banks, and in infrastructure bonds, among other uses. There was another issue of exchange guarantee given to the issuing bank (SBI) for both the schemes. While there was no exchange loss under IMDs as the rupee appreciated, there was an exchange loss of 8.57 per cent under the RIBs, which was insignificant in the light of the positives of the bond. Authorities maintained that, all things considered, both these schemes eased the process of recovery from the aftermath of the Asian crisis and political uncertainties.

India faced a different kind of problem during the latter part of the period under reference. The liberalised capital account environment at home and benign international financial conditions led to substantial capital inflows, which complicated monetary and exchange rate management (also see Chapter 5). Current account deficit either remained low or recorded surplus for some intervening years. During 2001–02 to 2007–08, total net capital flows were close to US$243 billion while total net current account deficit was a little over US$15 billion. Capital inflows in excess of the current account deficit of around US$230 billion (on balance of payments basis) were added to forex reserves to avoid appreciation of the rupee. Private flows formed the major part of the inflows and they were of the non-debt type. This enabled India to prepay some of its external loans, which brought down the external debt to GDP ratio from 24.6 per cent as of end of March 1997 to 18 per cent at the end of March 2008. In fact, the international investment position improved significantly during this period. Net international liabilities, which were about US$81 billion as of end of March 1997, came down to US$51 billion at the end of March 2008.

Notwithstanding higher outflows, capital inflows (net) were on the rise since 2001–02. They rose from around US$8.6 billion in 2001–02 to US$11 billion in 2002–03. On the monetary side, there was large reserve money expansion. The Reserve Bank had absorbed a good amount of capital flows into its reserves to avoid appreciation of the nominal exchange rate. Capital flows complicated exchange rate and monetary management even more in the latter part of 2002. During January–September 2002, forex assets of the Bank rose by US$19 billion. To stem accretion, policy focus shifted to further liberalisation of outflows.

The Annual Monetary Policy Statement of April 2004 discussed the key issue faced by the authorities, which was to decide whether capital flows were of a permanent and sustainable nature or temporary and subject to reversals. This being difficult to settle, the issue of whether to use market-based (withdrawing liquidity by the central bank) or non-market-based techniques (quantitative barriers) to deal with excess capital flows cropped up. The policy statement discussed several possible responses such as trade liberalisation, investment promotion, liberalisation of capital outflows and liquidating international liabilities. The Reserve Bank took several measures to mitigate the impact of capital flows, which have been mentioned earlier.

As capital flows remained buoyant, sterilising excess capital flows became a major concern for the policymaker. The monetary management part of the story has been told in Chapter 3. The chapter discusses the setting up of a Market Stabilisation Scheme (MSS). Under the MSS, T-bills and dated securities of the central government were issued for conducting sterilisation operations and the Reserve Bank followed the same method as for other government securities, that is, notified the amount, tenure and timing of issuances under the MSS. Money raised under the MSS was held by the government in a separate identifiable cash account maintained and operated by the Bank. The amount held in this account was appropriated only for the purpose of redemption of the MSS securities. The increase in the Bank's net foreign assets was largely matched by accretion in government balances under the MSS, shrinking the net Bank credit to the government, thereby neutralising the monetary impact. The impact on the Union Budget was only to the extent of interest paid on such securities.[57]

The IMF invited India in September 2002 to participate in its Financial Transaction Plan as India's forex reserves had reached a respectable level and its balance of payments position was also comfortable. As a result, India became a creditor to the IMF. Not long before, India had paid the last instalment of an IMF loan (in April 2000) taken in the wake of a balance of payments crisis in 1991. The Financial Transactions Plan means the following: when members borrow from the IMF, the latter finances its lending from a general resources account where quota resources are held. Loans requested in foreign currency are financed by converting the quota resources paid in domestic currency. Members to finance IMF transactions are selected from across its membership based on the assessment of a member's balance of payments and reserve position, including developments in exchange and financial markets and the adequacy of the member's international reserve assets. When a member participates, its international reserves undergo a compositional shift with a fall in the forex holdings being entirely offset by an increase in its reserve tranche position in the IMF.

From 2004–05 to 2007–08, a number of relaxations were made with regard to capital account transactions. Prime Minister Manmohan Singh, while releasing *The History of RBI, Volume 3* on 18 March 2006, requested the Finance Minister and the Reserve Bank to revisit the subject of capital account convertibility and suggest a road map. Tarapore II was the outcome.

The Committee on 'Fuller Capital Account Convertibility' under the chairmanship of Tarapore was set up on 20 March 2006. The report detailed a broad five-year time frame for movement towards fuller convertibility of the rupee in three phases: Phase I (2006–07), Phase II (2007–08 to 2008–09) and Phase III (2009–10 to 2010–11). Besides, it reviewed the international experience and produced the report card of the implementation of Tarapore I. It made far-reaching recommendations in seven areas: money market,[58] government securities market,[59] foreign exchange market,[60] fiscal consolidation,[61] the banking system,[62] monetary policy,[63] and the external sector.[64]

Portfolio Investment

Of the main forms of inflow and outflow, FDI was stable in nature and relatively moderate in scale in the period under discussion. However, portfolio investment was different – it directly entered the financial sector, was large in scale, and volatile in nature. FII inflow, therefore, concerns stabilisation issues directly. FII inflow (net) was large, increasing from around US$3.3 billion in 1996–97 to US$11.4 billion in 2003–04 and to as much as US$27.4 billion in 2007–08, but they were volatile as they recorded outflows in some quarters or years in between.

Until 1992, only NRIs and OCBs could undertake portfolio investment in India, which remained very small. Within a few years, the doors were opened to FIIs to invest in the Indian market. To begin with, they were allowed only in the equity market with sectoral caps. Ceilings on FII investments were progressively relaxed and aggregate investment by FIIs in a company was allowed within the sectoral cap prescribed for FDI. Indian debt market was opened to FIIs gradually. The government decided to permit FIIs in the category of 100 per cent debt funds to invest in dated government (central and state) securities in both primary and secondary markets in March 1997. In mid-1998, they could buy short-term T-bills. Indian corporates were also allowed to access equity capital from foreign sources in the form of depository receipts and euro issues.

From 1998, FIIs could invest in dated government securities. In June, fresh equity investments by FIIs were allowed for forward cover, which was raised subsequently in August to 15 per cent of the market value. In August, limits for investments in Indian companies were enhanced; ceilings applicable to portfolio investments in shares and debentures of an Indian company were raised from 1 per cent to 5 per cent of their paid-up equity capital of the company concerned. The Reserve Bank introduced a new scheme for investment by NRIs and OCBs of up to 51 per cent in the new issues floated by Indian companies, which were not listed on the stock exchanges and granted general permission for issue and export of shares by Indian companies, withdrawing the earlier 40 per cent scheme. In April 2000, Indian companies (other than banking companies) were permitted to enhance the aggregate ceiling on FII investment from 30 per cent to 40 per cent of issued and paid-up capital of the Indian company. Further enhancement of investment limits and permission to FIIs to hedge the market value of their entire investment in equity were announced in 2002 and 2003.

In October 2004, the requirement of prior approval of the Reserve Bank for transfer of shares and convertible debentures (excluding financial services sector) was dispensed with and general permission accorded, subject to compliance with the terms and conditions and reporting requirements, for transfer by a person resident in India to a person resident outside India and vice versa. Increase in foreign equity participation by fresh issue of shares, as well as the conversion of preference shares into equity capital, was allowed, provided such increase fell within the sectoral cap in relevant sectors and were within the automatic route.

The Reserve Bank monitored the aggregate ceiling of investments by FIIs/NRIs in Indian companies on a company-wise basis under the Portfolio Investment Scheme. The Bank was issuing an early warning signal to the companies – placing them in the caution list – as well as to their bankers after certain threshold limits of FII exposure were crossed. A meeting held on 28 June 1997 decided that the early warning would be given at 2 per cent below the applicable limit of FII investment in a particular company. On 27 December 2002, M/S Bharati Tele-Venture Ltd wrote to the Bank requesting a raise in the cut-off point as their company had a large capital base. The Bank considered the request favourably and proposed a relaxation of the trigger limit to 0.5 per cent below the applicable ceiling with respect to companies that had a capital base of ₹10 billion or more. After obtaining SEBI's views, Executive Director K. J. Udeshi wrote to Finance Secretary S. Narayan on 31 January 2003 for the approval of the Ministry of Finance. In reply, on 27 February 2003, G. S. Dutt, Joint Secretary, Ministry of Finance, drew the Bank's attention to the observations of the Joint Parliamentary Committee in its report on the stock market (Ketan Parekh) scam presented to the Parliament on 19 December 2002. Para 8.78 of the report stated,

> The Committee does not agree that RBI should leave it entirely to the custodian Banks to monitor compliance of its guidelines regarding OCBs. There is no system of periodical inspection of OCB accounts of Banks by RBI. RBI claimed that its role was limited to monitoring OCB's company-wise investment ceiling of 10 percent. The Committee notes that RBI's monitoring failed to detect violations of even this limited aspect. It is only after SEBI's investigation that violations regarding ceiling norm came to light.

He, therefore, said the proposal could be agreed to by the government, provided a mechanism for monitoring investment by non-residents was ensured. The Bank in its response not only explained the system put in place for monitoring but also gave the reason why it did not agree to SEBI's proposal of extending the trigger limit of 0.5 per cent to all companies. The Bank began issuing alerts based on the new norm after the press release of 19 April 2003.

The inflows of FII investment were constantly monitored by the Reserve Bank as well as by SEBI. As inflows swelled, the short-term nature of flows under certain categories of FII investment attracted the attention of the policymakers. The Bank was always concerned about the quality of FII investment. One of the matters for discussion under FII investment was the investment through participatory notes (PNs), which were instruments issued by registered FIIs to overseas investors who wanted to invest in the Indian stock markets without registering themselves with SEBI. PNs could also be issued by the sub-accounts held with registered FIIs. Thus, there were multiple layers of investors, such as registered FIIs, sub-accounts and PNs. When FII inflows were rising, there was a view that 'hot money' was flowing into India.[65] The PN route investment was substantial.[66] The matter was discussed in the HLCCFCM meeting on 23 October 2003.[67] SEBI issued a notification amending the SEBI (FII) regulations, 1995, that PNs should be issued only in favour of those entities that were regulated in the countries of their incorporation, and existing PNs should be liquidated when such contracts expired.[68] The Bank, and Governor Reddy in particular, who had raised the issue at high levels were concerned that the nature of the beneficial ownership or the identity of the investor might not be known in this case, unlike in the case of FIIs registered with a financial regulator. This and other cautionary arguments did not find favour in the expert group[69] that considered the matter. The Bank, however, submitted a dissent note (Box 4.3).

Box 4.3 Extract from the Dissent Letter of the Reserve Bank (28 October 2005)

While the thrust of the report is towards encouraging FII flows, sufficient attention also needs to be given to addressing the macroeconomic implications of the volatility of capital flows. In the light of the concerns highlighted by us during the discussions of the [Expert] Group from time to time and based on our written responses, we suggest that the following points should be considered while finalizing the recommendations of the Group:

A) Measures to contain volatility: In view of macroeconomic implications, impact on financial stability, especially on the exchange rate, and fiscal vulnerability, apart from monetary management, a special group may be constituted to study measures to contain large volatility in FII flows as a priority.
B) Measures to encourage FII flows: As already indicated in the earlier report of the Committee on Liberalisation of FIIs, caps may be set which will be of three types, viz. (i) a separate cap on FDI, (ii) a separate cap on FII and (iii) a composite cap on FDI and FII combined together.
C) Winding down of Participatory Notes (PNs): The Reserve Bank's stance has been that the issue of PNs should not be permitted. Major concerns of PNs are that the nature of the beneficial ownership or the identity of the investor will not be known, unlike in the case of FIIs registered with a financial regulator. Trading of these PNs will lead to multi-layering which will make it difficult to identify the ultimate holder of PNs. Both conceptually and in practice, restriction on suspicious flows enhances the reputation of markets and leads to healthy flows. We, therefore, reiterate that issuance of PNs should not be permitted.
D) Hedge funds: In case there are any hedge funds registered with SEBI, they need to be looked at closely for deregistration.
E) Ceiling on holding of shares by FII and sub-accounts: The period prescribed for the unwinding of the investments (in excess of permissible limits) should be three years in line with the dispensation proposed in the case of PNs.

(*Contd.*)

(*Contd.*)

F) Operational flexibility to impart stability to the markets: Operational flexibility is required to facilitate the liquidity management of FIIs arising from a mismatch in their cash flows arising out of their operations in equity markets. But, it would not be appropriate to permit FII to treat debt securities (both government and corporate debt) as an investment avenue to address the issue of their cash flow mismatch. Since the requirement for operational flexibility is a narrow one, the ceiling should be on the total stock of FII investment in debt and not on an incremental basis as suggested. Therefore, the related recommendation may be deleted.

Since most of the recommendations of the Group have significant macroeconomic implications and also because policy actions based on them will be irreversible, considerable thought is needed to be applied before their implementation. We, therefore, suggest that the Expert Group Report, as well as the Report of the Special Group, indicated in paragraph 4(A) above, along with the Reserve Bank's comments, are placed in the public domain, for wider debate and consultation, before processing the proposals further.

External Commercial Borrowings

Corporates and public sector undertakings were permitted to access the international capital market for the purposes of expansion of existing capacity as well as for fresh investments. ECBs included commercial bank loans, bonds, buyers' credits, suppliers' credits, securitised instruments such as floating rate notes and fixed rate bonds, and commercial borrowings from the private sector window of multilateral financial institutions such as the IFC and ADB. Gross disbursements under commercial borrowings were significant during this period, rising from US$7.6 billion in 1996–97 to US$28.7 billion in 2007–08, with a two-way movement in the intervening years. Prudent external debt management policy, which was integral to capital management, guided the Reserve Bank's approach towards ECBs. While there were limits on long-term borrowings, short-term borrowing was controlled. However, long-term borrowings beyond ten-year maturity were kept outside the purview of ECBs. Policy focused on infrastructure and export sectors and end-use stipulations were relaxed over the years step by step except for loans relating to real estate and capital market. The maturity structure of ECBs was being closely monitored. As a result, unlike the Southeast Asian countries in 1997–98, India did not face the problem of mismatch in banks' external asset and liability – in terms of either currency or maturity – which insulated India from the contagion. The policy for ECB also encouraged the use of derivatives for hedging interest and exchange rate risks on underlying foreign currency exposures. Loans, raised by the private sector from international capital markets, with more than three years' maturity were classified as ECBs. While those with a maturity of one year or less fell under the category of short-term credits, loans with a maturity of less than three years were categorised as trade credits. ECB proposals were approved within an overall annual ceiling, keeping in view the sectoral requirements and the outcome of the balance of payments in the medium term. The principal elements of policy for ECBs included keeping the maturities long and costs low, and encouraging investments in infrastructure and export sectors. Utilisation of ECB proceeds was not permitted for on-lending or investment in the capital market and in real estate by corporates. End use of ECBs for working capital and prepayment of existing rupee loans were also not allowed since January 2004. Furthermore, the minimum average maturity for loans above US$20 million was stipulated at five years. Trade credits with a maturity period beyond one year and up to three years were permitted only for import of capital goods up to US$20 million per transaction.

As foreign investment in equity was liberalised, the only instrument available with the authorities for managing capital account was modulating debt flows. Accordingly, there was an indicative limit fixed every year for ECBs.[70] On 29 November 2004, the ceiling on corporate debt was removed, and there was an inflow of US$1 billion into corporate debt. As there were excess capital flows, the Reserve Bank suggested that SEBI may fix a ceiling on such inflows. On 2 December 2004, SEBI, after obtaining the approval of the government, fixed the limit of US$500 million of investment in corporate debt. ECBs were also subjected to all-in-cost ceiling in 2004, which was modulated depending upon the cycle of capital flows.

ECBs were also subjected to a 'dual route': automatic and approval (case-by-case approval). Gradually, the automatic route was expanded and the approval route was compressed.[71] In October 1998, the ECB limit of US$3 million or its equivalent at a minimum simple maturity of three years was raised to US$5 million or its equivalent. In March 1999, the Reserve Bank was empowered by the central government to consider proposals for raising ECBs up to US$10 million or its equivalent with a minimum average maturity of three years for utilising the proceeds for business-related expenses, including expenditure to be incurred in rupees under various windows.

This was in addition to the scheme under which the Bank considered applications from corporate, and others, for raising ECBs up to US$5 million. This limit was increased to US$100 million in June 2000. In September 2000, the Bank operationalised the automatic route for ECBs up to US$50 million. The refinancing of existing ECBs was also brought under the automatic route.[72]

The policy on ECBs was revised and streamlined in January 2004 in view of the need to replace the prevailing temporary restrictions on access to ECBs with more stable, transparent and simplified procedures and policies. Also, the aim was to enhance investment activity in the real sector, particularly in infrastructure, and to enable corporates to access resources from international markets at competitive rates. The review took into account subdued investment activity, challenges faced in external sector management, the past experience and borrowers' concerns in the administration of the ECB policy. The comfortable level of key indicators of India's external debt provided the necessary headroom for some increase in incremental debt in the form of ECBs to finance the real investment for higher growth.

The main element of the revised policy was an increase in eligibility limits for the automatic route from US$50 million to US$500 million with certain maturity conditions. All corporates, non-banking finance companies (NBFCs) and financial institutions, except banks, were made eligible borrowers. Interest rate spreads or all-in-cost ceilings were specified. ECBs with an average maturity of three to five years were subject to a maximum spread of 200 bps over the six-month London Interbank Offered Rate (LIBOR) of the respective currency in which the loan was raised or the applicable benchmark(s). ECBs with more than five years of average maturity were subject to a maximum spread of 350 bps. No bank guarantee was allowed. All ECBs satisfying the above criteria would be eligible under the automatic route up to US$20 million for ECBs between three to five years of average maturity and up to US$500 million for ECBs having an average maturity of more than five years. The eligibility criteria were applicable to foreign currency convertible bonds (FCCBs) also. All cases falling outside the purview of the automatic route in the new liberalised ECB policy were decided by an empowered committee of the Reserve Bank.[73]

NRI Deposits

The experience with the FCNR(A) scheme, which existed until the 1990s and as part of which an exchange guarantee was offered to banks, was not encouraging. The effective cost worked out to be high and the scheme accentuated the crisis in 1991 by recording substantial outflows. Therefore, the policy with respect to NRI deposits underwent changes subsequently. While the broad features and attractiveness of the scheme were retained, the emphasis was laid on reducing the effective cost of borrowing and outgo of forex. Interest rates on these deposits were steadily deregulated and interest rate ceilings were modulated in step with capital flow phases before they were completely freed. The reserve requirement was operated flexibly as a tool for managing capital flows in relation to the needs of the underlying conditions.

There were five types of NRI deposits prevalent during the period under reference: FCNR(B), NR(E)RA, non-resident (non-repatriable) rupee deposit, or NR(NR)RD, NRSR deposit account scheme and NRO accounts. Under FCNR(B) deposits, which were only term deposits and denominated in designated foreign currencies with fully repatriable benefits, exchange risk was borne by banks. NR(E)RA deposits, allowed under savings, current and term deposit, were fully repatriable and denominated in rupees, and thus exchange risk was borne by the depositors. The interest on these two deposits was revised depending upon the ebb and flow of capital inflows. In addition, after a review of the investment activities of OCBs, in consultation with the government, they were derecognised as a distinct eligible class of investors in India with effect from 16 September 2003. With a view to reducing the country's external short-term liabilities, deposits with the maturity period of less than one year were disallowed under FCNR(B) in October 1999 and under NR(E)RA in April 2003.

NR(NR)RD was initially non-repatriable but later interest income was permitted to be repatriated and thereafter principal also was made repatriable. Banks were allowed to fix the interest rates from the inception of the scheme (June 1992), even before such freedom was granted to domestic deposits. These deposits were exempted from the statutory liquidity ratio and the CRR for most of the period. NRSR deposits were introduced, with effect from 15 April 1999, for such persons who voluntarily undertook not to seek repatriation of funds held in such accounts and the interest/income accrued thereon. These accounts had the same facilities as well as restrictions that were applicable to domestic resident accounts of individuals with respect to repatriation of funds, with the exception that the investment of funds held in these accounts in shares/securities and immovable property would be governed by the existing exchange control regulations. Both the schemes were withdrawn in April 2002, with a view to providing full convertibility of deposit schemes for NRIs. The maturity structure of NRI deposits was also readjusted.[74]

Short-Term Credits

Short-term credits (debt) are those loans that have the maturity of one year or less. One of the key components of capital account management was keeping the short-term debt liabilities within manageable levels. It was believed that a large short-term debt exposure would lead to external sector vulnerability as borrowers faced financing/rollover risk, more so during a crisis when access to the international financial market becomes restricted. This could mean heavy net repayments on account of short-term maturing obligations, which could further aggravate the payment difficulties. Therefore, capital account management required careful planning of short-term exposure. In fact, short-term debt overhang had added to the 1991 balance of payments crisis.

After the crisis, trade-related short-term credits were allowed only for import purposes. Overall limits were fixed for contracted short-term credits of original maturity, within which the category of oil companies and the 'group of other importers' had separate shares. These limits were being monitored carefully and revised from time to time. The short-term debt based on residual maturity, meaning total claims or debt service payments falling due during a year, was also being monitored as this type was perceived to be more relevant from the point of view of capital account management. The Indian approach of close monitoring of short-term exposure was vindicated by the Southeast Asian crisis and helped India remain insulated.

However, the limits were relaxed later when the forex reserve became somewhat comfortable. The other segment of short-term debt was the short-term portion of non-resident deposits that was gradually eliminated. As explained elsewhere, deposits with maturity of one year or less were withdrawn under FCNR(B) in October 1999 and those under NR(E)RA in April 2003.

Another type of short-term exposure which received attention under capital account management was unhedged forex exposures of corporates, which could have resulted in larger payments in terms of rupees when the rupee depreciated. The Reserve Bank in its different monetary policy statements from 2001 to 2003 expressed concern over such exposures and cajoled banks to hedge them. As banks did not heed the advice, the Bank mandated that, henceforth, all foreign currency loans by banks above US$10 million could be extended only on the basis of a well laid-out policy by the banks' Boards to ensure hedging.

Rupee Debt

The Indo-Russian agreement of 1992 and 1993 specified that rouble debt owed to the erstwhile Union of Soviet Socialist Republics (USSR) be converted into rupees and made payable through exports.[75] On several occasions, prepayment of the entire rupee debt was proposed because its repayment arrangement was complex. A working group in 1997 suggested the dollarization and prepayment of total rupee debt with suitable discount.[76] The proposal was discussed in several Indo-Russian joint technical committees but no consensus emerged due to the absence of agreement on the rate of discount.

Russia was required to utilise the repayments of rupee debt only for purchases of *identified* goods and services from India. As Russia was not able to import specified items, rupee balances in Russian account with the Reserve Bank gradually accumulated to ₹46.23 billion as of 15 April 2007. In November 2007 a 'Letter of Exchange' signed between the Government of India and the Russian Federation stipulated, inter alia, that the accumulated rupee balances should be earmarked for productive investment in India. However, no investment materialised during the reference period.

Finally, when there was a surge in capital inflows in the early 2000s, many current payments were further relaxed. Although India had complied with current account convertibility conditions of Article VIII of the IMF in 1994, some limits continued to be in force for current transactions. Excess capital inflows provided an opportunity to further relax current payments.[77]

Indian Investment Abroad

Indian investment abroad rose from US$198 million in 1996–97 to US$2.1 billion in 2003–04 and to US$21.3 billion in 2007–08. On this issue, the approach was to facilitate direct overseas investment through joint ventures and wholly owned subsidiaries and the provision of financial support to promote project exports. There were two ways to do this: the automatic route and the 'normal' route (or case-by-case approvals). In December 1998, the ceiling for clearance of proposals for Indian investment under the automatic route was raised substantially. In 2002, the limit was again raised, and investment made free of certain conditions. Policies on ADRs and GDRs by Indian companies were also made liberal at the same time. Overseas business acquisition through this route was permitted under the simplified system in certain activities, including information technology and biotechnology. Such businesses could issue employees' stock options to their permanent employees.

The policy became more liberal during excessive capital flows. In 2003, listed Indian companies could invest in companies listed abroad.[78] For banks, the freedom to initiate trading positions, borrow and invest in overseas markets added enormous flexibility to the forex business. In April 1997, ADs were permitted to borrow from their overseas offices/correspondents as well as to invest funds in overseas money market instruments, which was essentially intended to augment banks' resources and strengthen the integration between overseas and domestic money markets. This was subject to limits and conditions, eased later. In March 2004, to rationalise these rules, the existing facilities were replaced by a single facility in terms of which all categories of overseas foreign currency borrowings, including existing ECBs and overdrafts in Nostro accounts not adjusted within five days, were not to exceed 25 per cent of their unimpaired Tier I capital.

Conclusion

India in the early 1990s had a closely regulated external sector. Deregulation came in the next fifteen years. Liberalisation led to impressive capital inflows. India's forex reserves rose from US$22 billion at the end of March 1996 to US$310 billion at the end of March 2008, and the ratio of net foreign assets to reserve money rose from around 38 per cent to nearly 130 per cent in the same period. The chapter shows how this transition occurred and the challenges that it gave rise to. It also illustrates a point often made about Indian reforms, that the reform process was 'gradualist'. Those critical of the Reserve Bank's external policies during this period suggested that a more open economy would have delivered higher growth, that the Bank's policies were too conservative, and that a constricted financial sector depressed growth. The gradualism, however, served India well when the 2008 global financial crisis broke out. Subsequently, the Bank's stance was vindicated, and Reserve Bank governors received international acclaim.[79]

Gradualism takes a concrete meaning in the context of external sector reforms. The Indian approach to international capital flows adopted an implicit hierarchy of various types of flows. The general aim was to encourage non-debt-creating flows as compared to debt-creating flows. Within debt-creating flows, long-term debt was preferred to short-term debt. In this hierarchical order, FDI was at the top, followed by FII investment into equities, since, though volatile, both market and exchange rate risks were borne by the investor.

While this hierarchical order governed the pace of deregulation, the environment was another governing factor. The advisory committees were, by and large, pro-reform but the pace of reform depended on market conditions. From this point of view, the first half of the 2000s saw a few exceptionally good years in terms of economic growth and capital market flows. This enabled the Reserve Bank to implement deregulation and institutional change with relative ease. After a decade of its endeavour to open up the forex market and manage capital account, the Bank noted in its *Annual Report 2007–08* that while in the medium term, development of financial market could alone meet the challenge of capital flows, which is a gradual process, in the short-run, capital flows would have to be managed with a set of well-crafted tools. The report further noted, '[T]he issue is not either financial market development or management of the capital account, but how much of each approach should be adopted in a given situation and over time while recognizing and taking into account the scope and prospects for reforms in the fiscal and real sectors.'

Notes

1. When Article VIII of the Articles of Agreement of the International Monetary Fund was accepted. Conforming to the provisions of Article VIII confers on its members the status of current account convertibility. India complied with the requirement and acquired current account convertibility in August 1994.
2. More specifically, it recommended Indian companies to invest up to US$50 million abroad, forex earners to retain 100 per cent of their earnings in exchange earners' foreign currency (EEFC) accounts, liberal limits for banks' foreign borrowing, phased raising of limits of individual outward remittances. It also permitted participants in the spot market to take part in the forward markets and currency futures. Tarapore I influenced the repeal of FERA.

3. And an end to the remittance limit of US$5,000 per transaction for miscellaneous purposes, as well as individual purpose-wise limits, subsuming these under a new aggregate limit of US$25,000.
4. Its suggestions ranged from hedging of forex exposures to further liberalization of rupee–foreign currency swaps, allowing banks to use their discretion to introduce structured products, adopting proper accounting standards for derivatives, extending closing time for interbank transactions, maintaining capital on the banks' actual overnight open exchange position rather than on the limit available, and monitoring interest rate risk using value at risk method (a statistical technique used to measure the level of financial risk of a firm or portfolio).
5. Working group under the chairmanship of P. K. Pain, Chief Executive, Foreign Exchange Dealers' Association of India, 2006.
6. The minimum average maturity of ECBs was reduced to five years for loans above US$20 million, and three years for lower amounts.
7. Under which Indian stockbrokers would be able to purchase shares and deposit them with the Indian custodian for the issuance of ADRs/GDRs by the overseas depository. These issues should be to the extent of the ADRs/GDRs converted into underlying shares.
8. Comprising members from the Reserve Bank, SEBI, Ministry of Finance and the Insurance Regulatory and Development Authority of India. All the issues, including major liberalization measures with respect to financial markets, were first deliberated in the high-level committee.
9. Up to US$500 million or equivalent with a minimum average maturity of five years.
10. For example, the system of monitoring the cancellations of forward contracts beyond US$500,000 was reintroduced in November 1997. As the crisis spread, the facility of rebooking the cancelled contracts for imports was withdrawn on 20 August 1998, partly rescinding the permission granted in April 1997 to corporates to book forward cover for their export and import transactions through ADs. Subsequently, a limit of US$100 million for cancellation and rebooking was set for exports and imports separately. In December 2002, ADs were allowed to freely offer the facility of rebooking of cancelled contracts to all forex exposures falling due within one year. In June 2005, cancellation and rebooking of all eligible forward contracts booked by residents, irrespective of tenor, was reintroduced.
11. Up to 50 per cent of their forex earnings subject to certain conditions.
12. Headed by the Commerce Secretary and comprising members from the Ministry of Finance, Ministry of External Affairs and the Reserve Bank.
13. Vepa Kamesam, Deputy Governor, wrote a confidential letter to Finance Secretary S. Narayan, on 16 December 2002, drawing his attention to

Governor Jalan's discussion emphasizing the need for the Reserve Bank and the government to evolve a suitable mechanism to avoid delays in the disposal of applications. Inordinate delay had occurred in a few cases of approval, essentially because of the stance taken by the representative of the Ministry of Finance (see Appendix A4.1 for the full text of the letter).

14. From US$25,000 to US$100,000, or its equivalent.
15. Among further measures of liberalisation, corporates were allowed, in April 2007, to donate abroad subject to a limit of 1 per cent of their forex earnings during the previous three financial years or US$5 million, whichever was lower, and they were also allowed to remit up to US$10 million against the then prevailing limit of US$1 million for consultancy services for executing infrastructure projects. In June 2007, the limit for portfolio investment by listed Indian companies in the equity of listed foreign companies was raised from 25 per cent to 35 per cent of the net worth of the investing company, which was further raised in September 2007 to 50 per cent. Further, the requirement of reciprocal 10 per cent shareholding in Indian companies was dispensed with.
16. The limit of FII exposure to government papers was set at US$1 billion in 1998, which was subsequently raised to US$1.75 billion in November 2004, US$2 billion in April 2006, US$2.6 billion in January 2007, US$3.2 billion in January 2008 and US$5.0 billion in June 2008. Similarly, FII investment limit fixed for the corporate bond market was US$0.5 billion in December 2004, US$1.5 billion in April 2006 and US$3.0 billion in June 2008.
17. Which was closed along with non-resident (non-repatriable) deposit (NR[NR]D) accounts effective 1 April 2002 as part of rationalization of NRI deposits.
18. Such as to meet expenses in connection with the education of their children (up to US$30,000 per year), meeting medical expenses abroad of the person or family (up to US$100,000) and repatriation of sale proceeds of immovable property (up to US$100,000 per year, subject to tax payment and other conditions). In January 2003, the existing restrictions on repatriation of funds out of NRO accounts for education, medical and other approved purposes were removed.
19. In April 2004, to provide consistency in the interest rates offered to NRIs, interest rates on deposits under non-resident (external) rupee accounts (NR[E]RAs) for one- to three-year maturity were set at par with the London Interbank Offered Rate (LIBOR)/swap rates for the US dollar of the corresponding maturity. Further steps to achieve a consistent interest rate policy has been discussed in the chapter on monetary management (Chapter 3). Interest rates on FCNR(B) deposits were allowed to be fixed on a monthly basis against the then current weekly basis, as in the case of NR(E)RA deposits. As capital flows were large, the debt component of such

flows was decided to be moderated. Therefore, in January 2007, interest rate ceilings on FCNR(B) and NR(E)RA deposits were reduced to LIBOR/swap rates minus 25 basis points (bps) and LIBOR/swap plus 50 bps, respectively. In April 2007, the ceiling on FCNR(B) deposits was reset at LIBOR/swap minus 75 bps and NR(E)RA at equal to LIBOR/swap rates.

20. In April 1999, these rules were further relaxed.
21. In the internal note put up by the Exchange Control Department on 3 October 2002, examining a proposal received from the Indian Merchants Chamber, Mumbai, that the policy of allowing individuals to retain up to US$2,000 in cash could be extended to hold the amount in a bank account, K. J. Udeshi, Executive Director, agreed and specified the eligible credits.
22. Listed on a recognised stock exchange and with a shareholding of at least 10 per cent in an Indian company listed on a recognised stock exchange in India, without any limit.
23. To US$100,000. Release of up to US$100,000 or its equivalent (against the existing limit of US$50,000 or its equivalent) to resident Indians by ADs was allowed for medical treatment abroad without insisting on any estimate from a hospital or doctor.
24. Among other measures, in February 2004, resident individuals were allowed to freely remit up to US$25,000 per calendar year for any current or capital account transactions, or a combination of both. The limits were raised further in May 2007 to US$100,000 and again in September 2007 to US$200,000. Under this facility, resident individuals would be able to acquire immovable property and hold bank accounts, immovable property, or shares, or any other asset outside India, barring specific countries.
25. Notification No. FEMA 21/2000, section 7.
26. Rajya Sabha, Dy. No. 3280 for 19 December 2006 by B. K. Hariprasad, MP.
27. The Reserve Bank further stated that the perception of the IB that the PIO status should be cancelled was not appropriate as FEMA did not provide for registration of persons as PIO or the cancellation of such status.
28. The International Monetary Fund (IMF) called this 'perhaps the most significant move'. IMF, 'India: Selected Issues', IMF Staff Country Reports, no. 112, Washington DC, 1998.
29. Within the bank's open position limit and maturity mismatch limits (gap limits).
30. In terms of which all categories of overseas foreign currency borrowings was not to exceed 25 per cent of their unimpaired Tier I capital as at the close of the previous quarter or US$10 million or its equivalent, whichever was higher.
31. In April 1998, the High-Level Committee on Banking Sector Reforms (Narasimham Committee II; also see Chapters 3 and 10) recommended that forex open credit limit risks of banks should be integrated into the calculation

of risk-weighted assets and should carry a 100 per cent risk weight. This was taken into account when Basel II norms were implemented. In April 1999, permission was granted to banks to crystallize their forex liability in rupees in select cases. ADs were permitted to allow remittances for the purpose of normal business operations of the office (trading or non-trading) or branch or representative outside India of Indian entities, subject to terms and conditions. In April 2004, entities other than ADs or authorized banks were prohibited from accepting deposits from NRIs, either through fresh remittances or by debit to their NR(E)RA/FCNR(B) accounts. Banks were also permitted to fix interest rates on non-resident deposits, thereby enabling them to raise funds at a commercially viable cost.

32. Up to US$20 million per transaction for a period of up to one year for import of all non-capital goods permissible under the foreign trade policy (except gold), and up to three years for import of capital goods, subject to prudential guidelines.
33. Settlement of claims in foreign currency with respect to general insurance policies in foreign currency, issued with the approval of the Reserve Bank, was permitted in October 2001, subject to specified conditions. In April 2002, insurance companies, registered with the Insurance Regulatory and Development Authority of India (IRDAI), were permitted to issue general insurance policies denominated in foreign currency and receive premium in foreign currency without the prior approval of the Bank.
34. With an individual cap of US$50 million and overall cap of US$500 million.
35. In an internal note of the Exchange Control Department (8 August 1998), Deputy Governor Jagdish Capoor suggested that general permission be granted to domestic mutual funds within the overall limit to invest abroad, and expressed no objection to the proposal of mutual funds' investment in depository receipts which would, according to him, increase efficiency because of two-way fungibility. On 14 January 1999 Governor Jalan remarked in a note, 'A great deal has happened since the announcement of the proposed scheme in October 1997, and there are considerable uncertainties about capital flows and BOP prospects.... [I]t may be better not to embark on this scheme.'
36. He noted on 28 February 2000 that 'the reserves position being much better than the previous year, this extension may be agreed to', and that 'SEBI may be informed that a reference is being made to the government for their concurrence'. Accordingly, a communication dated 16 March 2000 was sent to the government.
37. Which Deputy Governor Capoor had proposed five years ago. Mutual funds were allowed to invest in overseas index funds based on a decision taken on 5 April 2003.

38. SEBI wrote to the Reserve Bank to increase the individual limit of US$50 million to US$100 million. A circular was issued on 26 July 2006 giving effect to all the three budget proposals. Subsequently, the limits were relaxed in a number of steps.
39. During the extensive discussion on both the Bills that followed, Finance Minister Yashwant Sinha said FERA was long thought to be out of tune with economic liberalization. Both the Bills were passed by the Lok Sabha on 2 December 1999 and sent to the Rajya Sabha. The Bills were laid on the table of the Rajya Sabha on 3 December 1999.
40. The Act along with the rules framed thereunder came into force on 1 July 2005.
41. *Hawala* refers to remittance systems.
42. To deal with contravention cases and decide the penalty, the government notification had fixed the quantitative limits in terms of amount involved per transaction for different levels of officers in the Reserve Bank – from Grade 'C' (Assistant General Manager) to 'F' (Chief General Manager). However, for effective implementation of the compounding process, the Bank had framed a set of rule-based instructions.
43. The reporting system was revamped as certain prescribed returns became no longer relevant with the introduction of FEMA, which is discussed elsewhere.
44. R.V. Gupta, Deputy Governor, was the Chairman.
45. Further, based on the recommendations of an internal group for preparing consolidated guidelines on derivatives, importers and exporters were allowed to write covered call and put options both in foreign currency and the rupee.
46. Expanded in October 1999 to include purchase call or put options to hedge their cross-currency proprietary trading positions within the overall value and maturity of the underlying instrument.
47. The forward contract had to be for a tenor of one year or more and could be rolled over on maturity. Foreign banks were permitted to hedge their Tier II capital in the form of head office borrowing as subordinated debt by keeping it swapped into the rupee at all times. Earlier, entities with FDI in India had to approach the Reserve Bank for case-by-case approval to hedge their investment.
48. To describe the unfolding of hedging policy for non-residents, in October 1997, NRIs were allowed to enter into forward/option contracts with ADs to hedge (*a*) the amount of dividend due on shares held in an Indian company, (*b*) the amount of investment made under portfolio scheme in accordance with the relevant provisions for the purpose and (*c*) the balances held in the FCNRB and NR(E)RA. Until November 2002, designated branches of ADs maintaining accounts of FIIs could provide forward cover with certain limits. From November 2002, ADs could provide forward/option contracts to FIIs

with rupee as one of the currencies, based on the declared market value of their entire investment in equity and/or debt in India. The cost of the hedge was to be met out of funds that could be repatriated and/or inward remittance through a normal banking channel. If the hedge became naked, the hedge could be allowed to continue until the original maturity. In order to facilitate dynamic hedging of forex exposures and keeping in view the size of the market in India and the large positions held by FIIs, it was decided to implement the flexibility for rebooking cancelled contracts in a gradual and phased manner. Accordingly, in February 2007, AD category-I banks were permitted to allow FIIs to cancel and rebook forward contracts up to a limit of 2 per cent of the market value of their entire investment in equity and/or debt in India.

49. Under the chairmanship of S. Gurumurthy, Executive Director.
50. A declaration that an exporter gives against each shipment that the full export proceeds will be realised.
51. The debate on this subject is reviewed in Dani Rodrik and Arvind Subramanian, 'Why Did Financial Globalization Disappoint?' IMF Staff Papers 56, no. 1 (2009): 112–138.
52. Statement at the 48th Meeting of the Interim Committee of the IMF, Washington DC, 28 April 1997, para. 9.
53. Reserve Bank press release, 20 August 1997; Y. V. Reddy, 'Exchange Rate Management: Dilemmas', Inaugural Address, XIth National Assembly, Forex Association of India, Goa, 15 August 1997.
54. To encourage early realization of exports, interest rate on post-shipment rupee export credit on usance bills for three to six months was increased by 2 percentage points to 15 per cent per annum for the period exceeding ninety days, which was subsequently restored to 13 per cent effective January 1998. Overdue export bills attracted 20 per cent of interest per annum, and an interest rate surcharge of 15 per cent of the lending rate was imposed on bank credit for imports effective 17 December 1997. Policy rates were raised on 16 January 1998 along with other measures.
55. To encourage exports, interest rate on pre-shipment credit was brought down from 12 per cent to 11 per cent effective 30 April 1998 and as a temporary measure, scheduled commercial banks were provided with export credit refinance at 2 percentage points below the Bank Rate between 6 August 1998 and 31 March 1999.
56. Apart from monetary measures, other measures included the enhancement of forward cover for FII investment, withdrawal of facility of rebooking cancelled contracts for imports, and restriction of the extension of time limit for repatriation of export proceeds to exceptional circumstances.
57. Interest amount paid by the government was of the order of ₹30 billion in the first year (2004–05), which progressively went up to over ₹84 billion in 2007–08.

58. Prudential regulations should be strengthened to encourage capital inflows; more players should be allowed to access the repo market; the repo markets should be allowed to cover corporate debt instruments; skills should be upgraded to develop the interbank term money market; prudential limits for commercial papers and certificates of deposit may be fixed; the market in interest rate futures should be activated and interest rate options should be allowed; and the Fixed Income Money Market and Derivatives Association of India (FIMMDA) should be suitably empowered to act as a self-regulatory organization to develop market ethics and trading standards, and also undertake regulation of participants, besides disseminating information.
59. The limit for FII investment in government securities could be gradually raised to 10 per cent of gross issuance by the centre and states by 2009–10. The allocation by SEBI of the limits between 100 per cent debt funds and other FIIs should be discontinued; short-selling across settlement cycles with adequate safeguards should be permitted; gilt funds should receive some tax exemption; non-resident investors be permitted to expand industry base; and repo facility in government securities should be widened by allowing all market players without any restrictions.
60. The spot and forward markets should be liberalized and extended to all participants, removing the constraint on past performance/underlying exposures; to nurture interest rate parity in forward markets, more flexibility may be provided to banks to borrow and lend overseas both on short term and long term, depending upon the strength of their balance sheet; currency futures may be introduced subject to risks being contained through proper trading mechanism, structure of contracts and regulatory environment; and the banking sector should be allowed to hedge currency swaps by buying and selling without any monetary limits.
61. The central and state governments should graduate from the present system of computing the fiscal deficit to a measure of the public sector borrowing requirement; and the Office of Public Debt should be set up to function independently outside the Reserve Bank.
62. All commercial banks should be subject to a single banking legislation; the minimum share of the central government/Reserve Bank in the capital of public sector banks should be reduced from 51 per cent (55 per cent for SBI) to 33 per cent; setting up of new private sector banks and conversion of non-banking finance companies (NBFCs) into banks should be encouraged; issues of corporate governance in banks need to be given early attention; and linking the limits for borrowing overseas to paid-up capital and free reserves, and not to unimpaired Tier I capital, as at present, raising it substantially to 50 per cent in Phase I, 75 per cent in Phase II and 100 per cent in Phase III.
63. The Reserve Bank should activate variable rate repo/reverse repo auctions/operations on a real-time basis and also consider somewhat longer-term LAF

facilities; the Bank and the central government should jointly set out the objectives of monetary policy for a specific period and this should be put in the public domain. A formal Monetary Policy Committee should be set up for strengthening the institutional framework.

64. A monitoring exchange rate band of plus/minus 5 per cent around the neutral real effective exchange rate (REER) may be considered and the REER should incorporate services to the extent possible. As an operative rule, if the current account deficit persists beyond 3 per cent of GDP, the exchange rate policy should be reviewed. Other recommendations include raising the overall ECB ceiling as also the ceiling for automatic approval gradually; keeping ECBs of over ten-year maturity in Phase I and over seven-year maturity in Phase II outside the ceiling and removing end-use restriction in Phase I; monitoring import-linked short-term loans in a comprehensive manner and reviewing the per transaction limit of US$20 million; raising the limits for outflows on account of corporate investment abroad in phases from 200 per cent of net worth to 400 per cent of net worth; providing EEFC account holders access to foreign currency current/savings accounts with cheque facility and interest bearing term deposits; prohibiting FIIs from investing fresh money raised through participatory notes (PN), after providing existing PN holders an exit route so as to phase them out completely within one year; allowing institutions/corporates, other than multilateral ones, to raise rupee bonds (with an option to convert into forex), subject to an overall ceiling that should be gradually raised; raising the annual limit of remittance abroad by individuals from the existing US$25,000 per calendar year to US$50,000 in Phase I, US$100,000 in Phase II and US$200,000 in Phase III; and allowing non-residents (other than NRIs) access to FCNR(B) and NR(E)RA schemes.
65. Refers to flow of *funds* (or capital) from one country to another to earn a short-term profit on interest rate differences and/or anticipated exchange rate shifts.
66. According to the report of the meeting of the Technical Committee of SEBI-regulated entities held on 29 October 2003, the PN route investment was as high as 28 per cent of the total net FII investments at the end of September 2003.
67. The minutes of the meeting noted, 'Governor [Y. V. Reddy], RBI observed that going into the original purpose for allowing FII investment, it is clear that only known and regulated entities should be allowed to make use of FII route and non-verifiable sources should not be allowed.'
68. Or within a period of five years from 3 February 2004, whichever was early.
69. The group was formed in November 2005 by the Ministry of Finance under the chairmanship of Ashok Lahiri, Chief Economic Adviser, Ministry of Finance.

70. For example, in 2003–04, the limit was US$9 billion, which was kept unchanged for the next year as well, and was progressively enhanced to US$16 billion in 2005–06, US$22 billion in 2006–07 and US$28 billion in 2007–08. Within the overall ceiling, a sub-ceiling was prescribed for investment in government securities and T-bills as well as corporate papers.
71. To track the policy developments, guidelines for ECBs were relaxed in June 1997, effecting: (*a*) ECBs of average maturity of ten years and above were kept outside the ECB ceiling and (*b*) ECB limits for telecom projects were made more flexible and an increase from 35 per cent to 50 per cent of the total project cost (including the licence fees) was allowed.
72. Among other measures, in March 2002, corporates were allowed to issue foreign currency convertible bonds (FCCBs) up to US$50 million in any single financial year under the automatic route, that is, without the approval of the government or the Reserve Bank. In September, in order to permit corporates to take advantage of low global interest rates, the Bank permitted prepayment of outstanding ECBs up to an amount of US$100 million without its prior approval. This liberalized automatic route was available to all categories of borrowers up to 31 March 2003. Proposals involving prepayment exceeding US$100 million would also be considered by the Bank expeditiously. Individuals, trusts and non-profit-making organizations were not eligible under the automatic route.
73. In October 2005, special purpose vehicles (SPVs) or any other entity notified by the Reserve Bank that were set up to finance infrastructure companies/projects were treated as financial institutions. Also, prepayment of ECB up to US$300 million against the earlier limit of US$200 million was allowed by ADs without prior approval of the Bank, which was further raised to US$400 million in April 2007.
74. As FCNR(B) deposits were allowed a maximum three-year maturity, it was announced in the Monetary and Credit Policy for 2003–04 that with a view to providing uniformity in the maturity structure for all types of repatriable deposits, the normal maturity period of fresh NR(E)RA deposits was also made one to three years; if a bank wished to accept deposits with a maturity of more than three years, it may do so provided the interest rate on such long-term deposits was not higher than that applicable to three-year deposits. Net inflows under NRI deposits were generally in the range of US$2.5 billion to US$4.3 billion per year during this period barring a few years in between.
75. See Reserve Bank of India, *The Reserve Bank of India, Vol. 4: 1981–1997* (New Delhi: Academic Foundation, 2013), Part A, p. 485.
76. Chairman: Y. V. Reddy, set up by the government on 'settlement of rupee debt owed to Russia', submitted its report on 12 March 1997.

77. For example, in 2003, the limit for advance remittance without bank guarantee by ADs was raised from US$25,000 to US$100,000 or its equivalent for import of goods into India, subject to specified conditions. As a matter of further liberalization, the limit of US$5,000 or its equivalent to be released by authorized persons to resident individuals in one calendar year, for any or more private visits to any country (except Nepal and Bhutan), was enhanced to US$10,000 or its equivalent. In July, the existing limits on remittances in respect of items, such as medical, employment, maintenance of close relatives and education abroad, were enhanced uniformly to US$100,000. In February 2004, resident individuals were allowed (under liberalized remittance scheme) to freely remit up to US$25,000 per calendar year for any current or capital account transactions or a combination of both. Under this facility, resident individuals were free to acquire and hold immovable property or shares or any other asset outside India without the approval of the Reserve Bank. Individuals could also open, maintain and hold foreign currency accounts with a bank outside India for making remittances under the scheme without prior approval of the Bank. The limit was raised to US$50,000 in December 2006 and applicable to remittances towards gift and donation by a resident individual as well. Subsequently, in May 2007, the limit was enhanced to US$100,000 and further increased in September 2007 to US$200,000 per financial year.
78. The latter would have the shareholding of at least 10 per cent in an Indian company listed on a recognized stock exchange in India (as of 1 January of the year of investment). Such investments were not to exceed 25 per cent of the Indian company's net worth, which was raised to 35 per cent in 2007, as of the date of latest audited balance sheet. Residents could invest without limit. Mutual funds were permitted to invest, with conditions.
79. The economist and Nobel laureate Joseph E. Stiglitz said, 'If America had a central bank chief like Y.V. Reddy, the U.S. economy would not have been such a mess' (*New York Times*, 'In India, Central Banker Played It Safe', 25 June 2009). Stephany Griffith-Jones, economist, said, 'I think not all countries are as lucky as India to have such common sense and balanced governors' (CAFRAL, 'Autonomy of the Central Bank', *Newsletter*, May 2014).