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## Anatomy of Exchange Control

Exchange control was introduced in India immediately after the outbreak of World War II in September 1939. There was no shortage of foreign exchange at the time of introduction of exchange control. The Exchange Control was conceived and designed by the British primarily for conserving non-sterling area currencies, especially the US dollar, in order to meet the war-time requirements of the British empire. In the thinking of the Bank of England, exchange control was a temporary measure, which would disappear with the end of the war. But such expectations faded and control, which was regarded as an intrusive activity, lingered much after the termination of the war.

Government notifications embodying the exchange control measures were issued under the Defence of India Rules. India, being a part of the sterling bloc, was requested to introduce similar regulations. From the outset, the Exchange Control was administered by the Reserve Bank of India, in accordance with the general policy laid down by Government of India in consultation with the Bank. The objective of the Control was to restrict the outflow of foreign exchange and to ensure that inflows of foreign exchange were promptly surrendered to the Control. Another aspect of the restrictive system was monitoring prompt realization of export proceeds. From the beginning, the Bank's involvement with exchange control was entirely technical and monetary in scope; it administered the country's gold and foreign exchange reserves, and acted as an agent of the government in matters pertaining to the administration of the Control. Much of the routine work of exchange control was delegated to certain commercial banks which acted as authorized dealers. These authorized dealers were permitted to buy and sell foreign exchange for specified purposes under regulations laid down by the Bank. Detailed control was exercised over the manufacture, acquisition, possession and disposal of gold in various forms through an organization headed by a Gold Control Administrator. Import and export

of gold, gold coins and gold bullion by residents was prohibited except under special authorization from the Reserve Bank. Established jewellers, however, were granted licenses to import gold for the manufacture of jewellery for export.

Initially, the government did not impose any restriction on the import of goods and merchandise. Foreign exchange was freely provided for the retirement of import bills. A legal basis for the import and export control system came into force with the Import and Export (Control) Act, 1947, which enabled the authorities to prohibit, restrict and control imports. From time to time the policy was tightened and reshaped to meet the development needs of the economy. From a war-time policy instrument, it was gradually transformed to meet development priorities. Schedule I of this order, which was periodically amended, listed all the imports for which a license was required. The Chief Controller of Imports and Exports was made responsible for administering the import policies formulated by the Ministry of Commerce. It was the task of the Ministry of Commerce to lay down, each year, the import policy to be followed, which was decided on the basis of availability of foreign exchange, the degree of shortages of commodities in the economy and the availability of domestic import substitutes.

The Reserve Bank assisted the government in the preparation of the foreign exchange Budget based on the balance of payments forecast, in which projected allocations of foreign exchange were made on an annual basis with mid-year reviews. The foreign exchange allocations were made according to an agreed system of priorities. The topmost priority was accorded to food, fertilizers and defence stores as well as for external debt service payments. Thereafter, priority was given to the imports of raw materials, and the capital equipment and goods required for executing various Plan projects. A bulk allocation was made in favour of channelizing agencies like the State Trading Corporation (STC), for imports of non-ferrous metals, iron and steel, etc. In the early and mid-1960s, when the foreign exchange situation was particularly tight, it so happened that after allocations were made for the priority items, there was hardly any exchange available for imports on private account. A study conducted by the Reserve Bank at the request of the Finance Ministry, of the licences issued, utilized and outstanding, revealed not only that the licences record maintained by the Commerce Ministry was in poor shape, but also that, at times, licences for imports were issued and revalidated against zero availability of foreign exchange. The RBI alerted the Finance Ministry to this and, with the assistance of the Bank, timely computerization of licensing data was undertaken, which went a long way in detecting the breaches and in giving a

more accurate indication of the availability of exchange as well as information on utilization of the licences.

Apart from import payments, other current account remittances, such as freight, royalties, profits, insurance premia, etc., were also tightly controlled. Restrictions were imposed on travel abroad. Repatriation of export proceeds was closely monitored to ensure that the proceeds were promptly realized and surrendered to the Exchange Control. The introduction of such restrictions in a vast developing economy like India, naturally gave rise to innumerable problems. The initial task faced by the Control was answering colossal number of enquiries from the lay public. The Exchange Control staff handled this under the able guidance of Jeejibhoy and Maluste. Since the pressure of work was exceedingly heavy, as time went by, the staff had to be steadily augmented, both by engaging temporary hands and by appointing more qualified and professional staff particularly with banking experience. And as the staff increased, so did the regulations. As loopholes in the original provisions came to light, one by one, they were pulled tighter. The technical nature of this aspect of the work called for a high degree of professionalism and initiative, and it became necessary to build a team of professionals with a high level of integrity. To facilitate the administration of the Control, the notifications and instructions issued by the Bank from time to time were codified in the form of an *Exchange Control Manual* for the guidance of both authorized dealers and the Exchange Control staff. The first such compilation was undertaken in June 1940 and thereafter, as amendments and revisions were effected, the *Manual* was updated from time to time. In course of time, the *Manual* became an indispensable reference document—a bible, so to say, for the staff handling exchange control matters.

In the late 1960s and early 1970s, as the foreign exchange reserves position became difficult, an edifice of further regulations was built on the foundations of the early measures; and instructions, definitions and arrangements essential for their enforcement were continually refined. A brief outline of the main developments in the exchange control policy as it evolved in that period might be helpful. The policy aspects of control maintained the basic framework introduced in the 1950s and 1960s. The emphasis continued to be to support the development of the economy. But, owing to the low level of foreign exchange reserves, payments and receipts of foreign exchange remained under strict control, with only marginal simplification in the early 1970s to facilitate the export efforts of certain industrial sectors. Basically, micro-decision-making characterized the Indian exchange control regime of the seventies.

Pressure on the Exchange Control Department to make the working of the control as simple and efficient as possible first came from RBI Governor L.K. Jha, who was not at ease with the way the control was administered. He was particularly keen to simplify the foreign exchange regulations that impinged on individuals. He was of the view that the Reserve Bank was basically organized to deal with corporates, especially banks, but discovered that a high percentage of the time of officials and staff of the Control was taken up in dealing with individual cases, involving petty amounts, resulting in delays in dealing with important cases involving large sums of foreign exchange. He observed that in formulating rules and procedures at the technical level, both the Finance Ministry and the Bank had made a conscious attempt to plug all possible loopholes. Consequently, the minute checks prescribed for the administration of exchange regulations had rendered the system top-heavy and time-consuming. The barnacles surrounding the controls required to be loosened and simplified, and broad judgement needed to be exercised in place of rule-based administration. In Jha's thinking, the Bank needed to move towards a new pattern of responsibilities, in which it was seen as an essential link between the interests of business and the demands of officialdom. In a letter dated 17 June 1968, he shared his thoughts on the matter with I.G. Patel, Special Secretary, Department of Economic Affairs, particularly in respect of the complicated travel regulations and the P form clearance procedures. As we shall see later, the P form relaxations were slow in coming and it was only towards the close of the 1970s, when the foreign exchange reserves position improved, that the Treasury had the nerve to scrap the P form altogether.

Before sketching the outlines of the major developments in the control system in the seventies, the major highlights of which are dealt with in the earlier volume, it is necessary to describe the legislative framework on which it was anchored. As mentioned earlier, exchange control was introduced in India at the outbreak of World War II and was regarded merely as a '*pis aller*' to be dropped at the end of the hostilities. As such, no need was felt for a separate legislation that would provide a legal backing to the various regulations. The post-war period witnessed gradual relaxation of controls in the developed countries but not in developing countries like India. In the case of India, exchange control had to be retained and made more stringent owing to the widening gap between the supply and demand of foreign exchange. Although India had accumulated large sterling balances, their use was highly restricted by the British in order to conserve the foreign exchange holdings of the sterling area. At the same time, efforts were under way by the UK authorities to remove or modify restrictions on the transfer

of sterling between countries outside the sterling area. Moves were also on to unify the many types of non-resident sterling into 'external sterling'. In the light of these developments, the need was felt by the Indian authorities to place exchange control on a statutory footing and provide legal backing to the measures taken by the government and the Reserve Bank. The Foreign Exchange Regulation Act (FERA) was passed in March 1947, bestowing legality on Indian exchange control measures. It was initially made valid for five years and, after two such five-year extensions, was put on a permanent footing in 1957. To begin with, a relatively simple system was in place but as experience was gained, the regulations were tightened. FERA, 1947, remained in operation for a quarter of a century, during which time it regulated the receipt and payment of foreign exchange and securities, and the import and export of currency and bullion. The legislation conferred on the authorities powers of search and seizure.

The first whiff of criticism about the inadequacy of control measures and the problem of leakages of foreign exchange came from the findings of the 56<sup>th</sup> report of the Public Accounts Committee for the year 1968–69. So as not to appear unconcerned or cavalier, the government promptly appointed a Committee to examine the leakage of foreign exchange through invoice manipulation, under the chairmanship of M.G. Kaul, Additional Secretary, Department of Economic Affairs. The Kaul Committee made certain vital recommendations in this regard.

The Committee estimated, on the basis of what it described as an 'educated guess', that the total yearly leakage through unauthorized foreign exchange transactions was in the region of Rs 240 crore. Identifying the components, it placed smuggling at Rs 160 to 170 crore, travel at Rs 35.40 crore, and over-invoicing of imports and under-invoicing of exports at Rs 25–30 crore. The demand for foreign exchange, the Committee indicated, was met from four sources—sale proceeds of goods smuggled out of India, like silver, precious stones and antiques; deflection of inward remittances to unauthorized channels; foreign currency obtained unauthorizedly from foreign tourists visiting India; and manipulation in relation to exports and imports. The Committee claimed that smuggling was the largest culprit, yet it confined its examination of the leakage through manipulation to the trade area. Thus the core of the problem remained outside the purview of FERA.

Experience gained from the working of FERA, 1947, for a quarter of a century indicated that it was not a very comprehensive legislation; several of the exchange control regulations prescribed by the Reserve Bank over the year were not incorporated into the provisions of the Act and this made

it difficult to enforce the provisions effectively. Both the Bank and the government were conscious of the fact that 'control' was neither logical nor complete, and that they were being criticized for permitting anomalies and winking at leakages. They took a joint view to explore the feasibility of amending and consolidating the Act, and to set right some of the glaring deficiencies and lacunae that prevented proper administration of FERA. The areas identified for strengthening were branches of foreign companies and foreign-controlled concerns, activities of resident foreigners including their terms of appointment, control over prompt realization of export proceeds, elimination of larger outgo of foreign exchange under imports, and enforcement powers to nab deliberate evaders. The Enforcement Directorate, taking into account court judgements and the difficulties in enforcing exchange control regulations, suggested to the government that certain amendments to the Act were desirable for proper administration of FERA. Likewise, proposals from various arms of the Control, viz. the government and the Reserve Bank, were put forward and these were intensively discussed at meetings attended by officials of the Department of Economic Affairs, Exchange Control Department and Legal Department of the Bank, the Ministry of Law, Ministry of Foreign Trade and the Directorate of Enforcement.

The question of amending FERA, 1947, was first discussed at a meeting held in May 1969 between I.G. Patel, Secretary, S.S. Shiralkar, Additional Secretary, both from the Department of Economic Affairs, and L.K. Jha, Governor of the Bank. At this meeting and subsequent ones, the officials were preoccupied with regulating the activities of branches, subsidiaries and foreign-controlled companies operating in India, and the employment of foreign nationals by business concerns in India. The Department of Economic Affairs prepared a draft summary of the discussions for the Cabinet Committee, which was earlier circulated to the Bank and the concerned Ministries for their comments. This was the beginning of an exercise that ultimately provided shape to FERA, 1973.

The Reserve Bank's influence on the shape of FERA, 1973, is difficult to ascertain, but there can be no doubt that its Exchange Control officials and Legal Department staff were actively involved in examining the proposals and in submitting revised draft amendments. The revised draft with an explanatory note forwarded to the Department of Economic Affairs bore testimony to the hard work and careful examination undertaken by the Bank. But the fact remains that the key players were all civil servants drawn from the government—I.G. Patel, S.S. Shiralkar and L.K. Jha. While Jha was then the Governor of the Bank, leaving for an ambassadorial assignment in 1971,

Shiralkar was appointed Deputy Governor in 1970, and was involved in coordinating the amendments and directly associated with framing the new Act. Jha, as Governor, closely monitored the progress of the FERA amendment exercise and, towards the end of 1970, requested the Exchange Control Department to give a tabular status report on the purpose and position of each proposed amendment, which was duly produced. A wide measure of consensus had emerged on the key amendments needed to give a comprehensive look to the new legislation. But the challenge of drafting the precise amendments remained; the government and the Bank were preoccupied throughout 1971 and much of 1972–73 in arriving at an acceptable version of the draft amendments, taking into account the oral evidence given by trade, industry, representatives of the RBI and others before the select Joint Committee on the Foreign Exchange Regulation Bill.<sup>1</sup> To one and all of the questions raised, the Bank furnished relevant replies, complemented by statistical data wherever possible.

At the conclusion of the oral evidence given by the Reserve Bank representatives, the chairman of the Joint Select Committee directed the RBI to prepare a note indicating the new powers contemplated to be granted to the Bank under the amended FERA Bill and how these would prevent evasion of exchange control.

The basic structure of the new Bill was no different from the existing FERA, 1947; the new provisions and amendments were woven into this existing basic structure. The proposed provisions were classified into five groups: (i) transactions requiring the Bank's approval, (ii) provisions for giving a legal basis for some existing procedures, (iii) deeming provisions placing the onus of proof on parties concerned, (iv) provisions enhancing penalties, and (v) clarificatory provisions.

The provisions covered under group (i) entailed conferring new powers on the Reserve Bank and, by and large, formed the met of the FERA revisions.<sup>2</sup> Exports shipped on consignment basis was one area of concern and evasion. The findings of the Kaul Committee had indicated that the realization effected in overseas markets after the goods had reached there and been sold provided considerable scope for abuse and evasion, as there was no provision in FERA, 1947, to enable the RBI to refuse permission for 'on account sale', which, in the Bank's judgement, was unreasonably low. Under the 1947 Act, an exporter was required to repatriate the sales proceeds

<sup>1</sup> Reserve Bank representatives appeared before the Joint Select Committee on 21 September 1972.

<sup>2</sup> Clauses falling in this group include: 13(1), 17, 18, 24, 25, 26, 27, 28 and 29.

within the prescribed period. But this did not always happen. In many cases, the foreign exchange earned was stashed away abroad. As a matter of administrative practice, the Bank permitted export on a consignment basis only after satisfying itself that adequate arrangements had been made for repatriation of the proceeds, and after seeing that the foreign importers had opened letters of credit covering the export consignment. But such administrative devices failed to check evasion. The need was therefore felt to fill the gaps by introducing suitable provisions in the Bill. Clauses 17(9) and (10) made it incumbent on the exporter to repatriate export proceeds within the prescribed period, failing which non-repatriation would be regarded as default. The onus to prove that the default was beyond the exporter's control was placed on the latter and not on the prosecution.

Likewise, there was a suspicion that in the case of imports, goods were over-invoiced, the objective being to build up unauthorized foreign currency balances. Provisions of the customs law dealt with cases where importers made remittances for imports, but either no imports were made at all, or the goods imported were inadequate or of inferior quality. The provisions of Section 4(3) of FERA, 1947, were suspect. The difficulty was in providing for the presumption that in the event of non-import of goods or import of substandard quality, the importer had misutilized the foreign exchange.

The entry of foreign capital was another area that needed strengthening. The FERA, 1947, provision was effective enough for regulating the entry of foreign capital in the form of acquisition of shares of companies in India by foreigners, but foreign investments, which were in the form of branch investments in India by companies, firms, individuals and residents abroad, remained outside its purview. The need was also felt to impose control over foreign capital that had already established a foothold in the country. The Reserve Bank pressed for legislation through the proposed amendment of FERA, to close this loophole. The incorporation of Clause 27 sought to bring all branches of foreign companies within the purview of the revised Act.

Likewise, FERA, 1947, prohibited acquisition by non-residents of shares issued in India without the specific or general approval of the Reserve Bank, but there was no direct provision regulating the transfer by non-residents of such shares to residents. Furthermore, there was no provision regulating the holding of real estate. The proposed amendment sought to bring such transactions within the ambit of the Bank's permission; permission would be needed to acquire, hold or transfer or dispose of immovable property.

Another lacuna in FERA, 1947, was there was no restriction on a



resident giving a guarantee to a non-resident in respect of the liability of another resident. This was rectified by the addition of sub-clauses 6(i) and 7(ii) to Clause 25.

Employment of foreigners was another area of concern. Under the provisions of Section 18A of FERA, 1947, restrictions of an indirect nature were imposed on the employment of foreigners, whether in India or abroad, in the trading or commercial fields or as technical or management advisers. Outside these limitations, it was found that arrangements entered into prior to 1 April 1965, as also those made to appear like principal-to-principal transactions, escaped the control net. Resident foreigners also remained outside the purview of Section 18A. Hitherto, the check on the entry and employment of foreigners was exercised more through the visa procedure. The loophole in the visa procedure was that British and Commonwealth nationals, who did not require a visa, could enter and take up employment in India without the knowledge of the Control. To exercise stricter control over the employment of foreigners and to monitor the foreign exchange liability arising therefrom, comprehensive enabling provisions were proposed through the addition of clause 26 in the proposed new Bill. Clause 28 made it part of law that a person could not, without the permission of the Reserve Bank, employ or continue to employ a national of a foreign state. Appointments prior to the enactment of the new Act also required the Bank's permission to continue such employment, failing which the Bank was empowered to close down the branch or place of business and terminate the appointment. The obligation was cast on the person or company so affected to approach the Bank for permission to carry on the activities. The 1947 provision required declaration of only foreign currency notes brought in by incoming passengers. Since the bulk of the amount was carried in the form of travellers' cheques, the new provision was extended to cover all forms of foreign exchange, enabling the Bank to demand a declaration for all forms of foreign exchange including travellers' cheques.

The Reserve Bank and particularly Governor Jha had been always uneasy in administering the provisions of P form applications, which were based on a terse provision of the law saying that 'no airline, shipping company or travel agent shall, except with the general or special permission of the Reserve Bank, and subject to such conditions, if any as may be specified therein, book for any person a passage for a journey outside India.' Experience of working with P form applications had revealed that the directions given in Section 20 of FERA, 1947, required proper legal underpinning. Further, the Bank had to be empowered to deal effectively with restrictions relating to overstay, or visits to countries not included in the original Bank

approval. Doubts were also expressed regarding the procedure in force for issue of licences to steamer/airline companies and travel agents. It was not clear whether Section 18B clearly authorized the Bank to require a travel agent to take out a licence. Suitable provisions for the granting and revocation of licences were therefore proposed. The Bank's management was clearly exercised that a considerable amount of the Control Staff's time was taken up in handling P form applications. What was more, the clearance and approval procedure in an overwhelming number of cases entailed exercising a wide degree of judgement and discretion. The machinery for aligning decisions at various levels, too, needed strengthening, and could be expected to function smoothly only if the Control staff and customers understood the accepted procedure and complied with it; every effort had to be made to help them do so. The Bank was aware that the P form for travel abroad—be it for business, pleasure, medical treatment or studies—was a constant and irksome reminder to the general public that they could not travel without that clearance. The Bank was therefore anxious to avoid the blame of administering the P form in an arbitrary and tyrannous manner, and sought, through an amendment of FERA, 1947, the requisite legal authority to administer the provisions in a fair and impartial manner.

In 1947, when the FERA was first enacted, only authorized dealers were permitted to conduct foreign exchange transactions. At a later stage the need was felt for granting licences with restricted facilities of changing foreign currency into Indian currency and vice versa. Money changers' licences were given by the Reserve Bank to firms operating at international airports, at the Indo-Pakistan land border, and at hotels and at tourist places, where such facilities would prove useful. As there was no provision in FERA, 1947, for such restricted dealers in foreign exchange, the Bank regulated the money changers through executive orders by treating the provisions in the *Manual* as directions under Section 20(3) of the Act. This anomalous situation was to be corrected and regularized through the introduction of a specific provision on 'money changers' in the FERA amendments.

Apart from the substantive amendments, there were a few provisions that related to administrative practices which were given a legal basis, such as clause 30 regarding P forms, licensing of passage agents, putting exporters on a caution list, blocking of assets of emigrants and imposing restrictions on the operations of non-resident accounts.

The set of provisions to help prevent evasions were of interest to the Directorate of Enforcement and the Reserve Bank had little to do with them. By putting the burden of proof in certain cases on the parties concerned, the provisions were intended to facilitate the task of the Directorate. The

provisions covering penalties for contravention of the 1947 Act were considered relatively mild. The revised amendments sought to enhance the penalties, inflicting more than ordinary punishment, including imprisonment, on the grounds of what the Law Commission called the social implications of the crimes. However, a major drawback of the deterrent provisions was that there was no evidence of the wider approach recommended by the Kaul Committee. The latter had stressed 'the importance in the entire field of educating public opinion about the grave economic consequences to the country of the activities of malefactors, who divert foreign exchange illegally. At the moment, suffering social odium does not attach to this malpractice.' In the view of the Committee, 'a properly directed and sustained campaign to create public consciousness about what is at stake in terms of the economic well-being of the country would yield rich dividends.' But this suggestion was not given very serious thought; instead, the authorities continued to rely on policing and punishing rather than educating public opinion.

The first note for the introduction of an Act consolidating and amending FERA, 1947, was submitted by I.G. Patel for consideration by the Cabinet at its meeting on 24 May 1972. The Cabinet decided that a more detailed consideration of the proposals contained in the note would be necessary before any decision could be taken. Some of the comments/guidelines that emerged from the Cabinet discussion were: the term non-resident needed to be defined; the proposal to provide for interception of postal articles and telegrams by the Directorate of Enforcement to facilitate the tracking down of illegal transactions involving foreign exchange, as recommended by the Law Commission, required to be discussed further with the Ministry of Law by the Minister of State in the Ministry of Home Affairs. In this latter matter, the Finance Ministry and the Personnel Department of the Home Ministry were at loggerheads. While the Department of Personnel was keen to incorporate the provisions on the lines of the Law Commission's recommendation into the Act, the Ministry of Finance had reservations on the grounds that custom authorities were already armed with the necessary powers to intercept and examine postal articles. The Ministry was apprehensive that interception of inland mail and telegraphic messages under cover of the Act would invite criticism from the opposition as an invasion of personal liberty.

On the general need to amend and consolidate FERA, 1947, the Reserve Bank and the Finance Ministry were in complete agreement. Close and regular contact was maintained through middle-rank officers, and a comfortable working relationship existed between the Bank and the Depart-

ment of Economic Affairs. In August 1965, the Bank sent to the Government a draft Bill for amendments to Sections 12 and 18B of FERA, 1947, and the insertion of a new Sections 12A. Several other amendments were suggested from time to time. In November 1967, Y.T. Shah, Joint Secretary, Ministry of Finance, in a letter to Deputy Governor Adarkar, suggested that, instead of piecemeal amendments, the Bank should undertake a comprehensive review of the Act and forward its recommendations to the government.

Thareja, Controller, Exchange Control Department, impressive in his command over detail and committed to the philosophy of a controlled exchange regime, was assigned the task. With the aid of middle-line colleagues, the Department prepared a tabular statement extending over thirty sheets indicating the position in regard to various amendments, and forwarded a copy to the Bank's Legal Department for its consideration and comments. R.M. Halasyam, the legal adviser, carefully studied the suggested changes and recorded his detailed comments across thirteen pages. After further scrutiny and processing by the Exchange Control Department, he forwarded the same to P.K. Kaul, Director, Department of Economic Affairs. For over a year there was no response from the government; on 15 November 1969, the Bank was informed that the government had considered the proposals and wished to introduce a Bill in the forthcoming session of Parliament to amend a few of the provisions of FERA, 1947.

The difference between the Bank and the Treasury was not only a matter of emphasis but of substance. Through a telex message, the Bank conveyed that the amendments suggested by the government for the forthcoming session of Parliament were not material or necessary as the policy issues were 'neither too pressing nor of great importance in comparison with other proposals'. In the meanwhile, concerned officials in the Legal and Exchange Control Departments gave a second look to the earlier tabular proposals and, after some modifications, they were discussed with Y.T. Shah of the Ministry of Finance during his visit to Bombay in January 1970. After the discussion, the rough edges of the proposed changes were smoothed out and forwarded, in mid-January 1970, to Y.T. Shah.

Based on the suggested amendments, the Finance Ministry directed the Ministry of Law to prepare a draft Bill, a copy of which was forwarded to the Exchange Control Department for their comments. Officials of the Exchange Control and Legal Departments of the Bank discussed the draft provisions of the Bill among themselves. Thereafter, the legal adviser, Halasyam, recorded a note on 21 April 1972, setting forth the Bank's comments. Every provision was scrutinized in the minutest detail before the

Bank's version was forwarded to the government. The draft Bill was discussed for the first time at an inter-ministerial meeting convened by the Department of Economic Affairs that was presided over by S. Krishnaswamy, Joint Secretary, and attended by representatives of the Ministries of Finance and Law, and the Directorate of Enforcement and Reserve Bank. The Bank was represented by the controller, Thareja, and the legal adviser, Halasyam. In drafting the Bill, the Bank's advice was sought and accepted in technical matters but some of the changes were determined by inter-ministerial considerations and by the perceived notion to retain the levers of control with the different Ministries.

The marathon three-day meeting discussed as many as 63 issues pertaining to various clauses of the draft provisions. Drawing on its experience and the difficulty encountered in justifying to the courts the need for regulation of transactions in the Indian currency and their indirect effect on foreign exchange resources, the Bank advised that the preamble should also refer to 'transactions indirectly affecting the foreign exchanges'. Keeping in mind the court judgement in the Vasanthi Raman case, it was agreed to accept the suggestion. The Bank also advised having an enabling provision to take care of the situation, should it prove difficult to bring the whole Act into force on the same date. It was also accepted that a company in India whose foreign equity was 40 per cent or more would be deemed foreign-controlled; that provision would be made to regulate foreign-controlled companies operating in India and accepting deposits from residents in India; to call for particulars of immovable properties held; and to require holders of foreign securities to submit periodical returns. The Bank's suggestion to empower the Exchange Control to inspect the books of money changers, airlines and steamship companies licenced by the Bank was accepted.

The Bank opposed, in no uncertain terms, the bestowing of legal powers on the Directorate of Enforcement to inspect the books of authorized dealers. Deputy Governor Shiralkar, after discussing the issue with the Governor, tried to dissuade the government. In a longish noting, Shiralkar recorded:

The Directorate of Enforcement has the power to search premises and also to call for documents and examine persons. Moreover, under existing Section 19H, the Central Government and the RBI can get authorized dealers' books inspected by their officers. If in any particular case, the Central Government wants the books of an AD to be inspected otherwise than through the

RBI for some reason, it can always get it done officially by appointing an officer who could be an official of the Directorate of Enforcement if necessary. A special authorization in favour of the Director is, therefore, not necessary as the requirements can be met under existing provisions. Further, we would prefer a general provision of the kind present in Section 19H rather than one where the Director of Enforcement can inspect AD's books without reference to anybody. This will ensure that only in somewhat special circumstances, the Central Government would utilize the powers and have the inspection carried out, otherwise than by the RBI. A dual authority in respect of inspection of ADs is likely to lead to confusion.

These were sensible remarks based on the Bank's experience of regulating authorized dealers intelligently and efficiently. Even the Indian Banks' Association, whose members were authorized dealers, appeared before the Joint Committee and deposed that special authorization by law, enabling the Enforcement Directorate to inspect the books of dealers, was not necessary. The views of the RBI were upheld and the authority of the Control was in no way diluted.

The revised Bill, with which Bank officials Thareja and Halasyam were closely associated at the inter-ministerial level, was by and large acceptable to the Reserve Bank, barring a few reservations—these related to the definition of residents, the P form and transfer of property by/to non-residents.

Regarding the P form, the Control drew the attention of the government to the fact that clause 30(8) of the draft Bill elaborated that a P form application would be rejected only if, in the opinion of the Bank, such travel directly or indirectly involved the accrual of or expenditure of foreign exchange. Hitherto, the practice had been to give passage clearance for visits on the basis of invitations extended by foreign governments but after seeking the concurrence of the Indian government. This meant that the P form regulation was being used as a means for enforcing a non-exchange control measure which could be struck down by the courts. The RBI's position in the field of exchange control policy was quite different from its position as the Central Bank. In exchange control matters, it was no more than an agent for executing the government's policies, there being very little or no delegation. It therefore advised the government to take note of this observation.

With reference to the Enforcement Directorate's proposal to have a definition of the term 'resident' incorporated in the Bill, the Reserve Bank was

of the view that it was difficult to formulate a precise definition of the term that would meet the requirements of exchange control; it was, therefore, not in favour of defining the term. Definition along the lines of the Income Tax Act was considered inappropriate and unsustainable, for under FERA, the relevant issue was whether the person concerned was a resident or a non-resident on the date he did an act or entered into a transaction, and not whether he was in India during the 365 days prior to the transaction. Even the Code of Civil Procedure, which used the term resident, had not attempted a definition of the term. It was further pointed out by the Bank that the UK Exchange Control Act contained no definition of the term resident.

The fact that FERA, 1947, did not contain a definition of the term resident was not due to any inadvertence on the part of the framers of the Act but because of the genuine difficulty in formulating a precise definition. In 1963, when large-scale amendments were sponsored, this issue was taken up but abandoned due to the difficulties inherent in attempting an appropriate definition of the term. The Reserve Bank had always approached the administration of exchange control in the spirit of avoidance, wherever possible, of bureaucratic complexities, seeking to be helpful, rather than obstructive, while applying the rules in good faith as agents of the Treasury. On this issue too, it had provided some guidelines in the *Manual of Exchange Control* for determining the 'resident' status of persons. Including a definition in the law itself, the Bank felt, could make for lack of flexibility. But, despite the Bank's reservations, when the draft amendment Bill was discussed by the Cabinet on 24 May 1972 consensus was in favour of defining the term resident, and the Control was directed by the Finance Ministry to attempt a definition 'incorporating such conditions as the Bank considers necessary in such a definition in the light of the experience gained till now'.

Reluctantly, the Reserve Bank set about the task assigned to it. It proceeded on the basis that the definition should be such as to accommodate the procedures then followed in the matter of affording facilities to and imposing restrictions on various types of persons, as, otherwise, some persons may get an advantage, while additional restrictions may be imposed on some others, giving rise to complaints of hardship. The legal adviser, in consultation with the Control authorities, evolved a definition of the term 'resident' that appeared to suit the requirements while avoiding the deficiencies in the definition suggested by the Enforcement Directorate. The Bank, however, cautioned the government that under the proposed definition, there could be only two classes of persons—persons resident in India



and persons resident outside India. Foreign nationals staying in India on employment or business or vacation and treated as temporarily resident in India, would now have to be treated as resident in India and, by administrative decisions based on policy, be eligible to enjoy the same facilities currently enjoyed by them. The Bank also pointed out to the government that the proposed definition would not be applicable to corporate bodies, their offices and branches. This was because the question of when a branch or office of a corporate body should be treated as in India or outside was a settled issue under Section 20(i) of the Act and the need for such a provision in the definition was not necessary.

The definition of the term 'person resident in India' was finalized after taking the approval of the RBI Governor. Deputy Governor Shiralkar, while forwarding the definition to the government, advised that it had not been possible to define the term precisely or to avoid a certain amount of roundaboutness. The Bank had done the best it could, but it had not been able to work out the full implications of the definition in relation to the various clauses in the draft Bill. No doubt, the Bank had formulated the definition carefully and after considerable discussion, but including the definition in the law itself remained a worrisome aspect for the Control. Shiralkar confessed to the haunting thought that 'conceivably some persons may be able to take advantage of it to avoid coming under the mischief of the restrictions, which they would under the Act as it now stands', and concluded his message on the note that the Bank 'feels it is desirable to exclude such a definition from the new Act'.

As a consequence, another inter-ministerial meeting was organized in the third week of July 1972 between officers of the Reserve Bank, the Ministry of Finance, the Ministry of Law and Justice and the Directorate of Enforcement, at which a few modifications were made in the definition as proposed by the Bank, including a separate provision to cover citizens of India who had never been in India after 25 March 1947 (the day on which FERA, 1947, came into force).

Transfer of property by/to non-residents was another grey area for the Control. The Enforcement Directorate invited the attention of the Control to the fact that several non-residents were transferring their savings to India through unauthorized channels for investment in real estate. With a view to plugging this weak spot, the Directorate suggested that FERA, 1947 should be amended in such a manner that the Registrar of Immovable Properties would register transfer documents relating to immovable property in excess of Rs 50,000, only after the non-residents secured a 'no objection' certificate from the Reserve Bank. Informally, the Bank had been



observing such a practice but it lacked legal backing. Henceforth it was decided to ensure that neither of the parties in a property transaction was a non-resident, and a new clause to that effect was inserted in the revised draft Bill. The clause would be applicable in the case of both sale/transfer to and sale/transfer by a non-resident. If either of the parties in a property deal was a non-resident, a 'no objection' from the Bank was made a legally binding requirement.

To safeguard the Bank's position, Governor S. Jagannathan asserted that the RBI would not get involved in the determination of residential status of the parties to the transaction. In the event of a registering officer refusing registration on the ground that a party to the document was resident outside India, the contending party could raise the matter only by way of an appeal that was available to him under the Registration Act. The Bank would confine itself to the question of whether it could agree to the transaction, even if one of the parties was a non-resident. Accordingly, clause 29 of the draft Bill was recast to provide merely that a non-resident could not transfer property in India without the approval of the Reserve Bank. At a later meeting, clause 29 was substituted by a new clause that sought to regulate in a direct way, the acquisition and holding of immovable property by a foreign national or company in which the non-resident stake was 40 per cent or more.

The modified draft Bill came up for Cabinet discussion on 17 August 1972. The Cabinet cleared the Bill for approval of the Lok Sabha with a proviso that the guidelines for implementation should be worked out in advance to facilitate implementation as soon as the Act came into force.

The Foreign Exchange Regulation Amendment Bill was introduced in the Lok Sabha on 24 August 1972 by Finance Minister Y.B. Chavan. The highlights of the 73 clause Bill, intended to regulate dealings in scarce foreign exchange, were: to plug exchange leaks arising from invoice manipulation in trade and in property deals, and to place a bar on foreign companies, particularly branches of foreign firms in trading activities. Under the new law, the latter would now have to get converted into Indian companies. Chavan clarified that cases of foreign investment in India that were then functioning without prior permission or in non-priority sectors would be reviewed on a case by case basis, but added that it would not be necessary or desirable to review cases of recent approvals, particularly in highly sophisticated technology or export-oriented industries. By an amendment, the Reserve Bank was empowered to exempt certain companies and persons from the provisions of this clause, based on the nature of their activities. However, the Bank could not exercise this power of exemption where

the activity was solely of a trading nature. A comprehensive list of restrictions was drawn up to cover the transfer and use of foreign exchange, export of gold and foreign currency, and control over immovable property owned abroad by residents and immovable property owned by non-residents in India. As foreign investment in landed property and buildings offered considerable scope for capital appreciation and consequently increased the nation's contingent liability by way of capital repatriation, the new policy stance was not to allow foreigners and foreign companies to enter into the real estate business. Together with foreign currency 'mobilization' through timely repatriation of export proceeds, close monitoring of exports on a consignment basis and tighter surveillance on over-invoicing of imports, these provisions gave the Central Bank extensive control over the external monetary resources of the country. They reflected the psychological reaction to the external liquidity crunch of the early 1970s and the defensive posture towards the international economy in the face of the development needs of the Indian economy.

Since the Bill was sure to attract explosive political reactions, with the concurrence of both Houses of Parliament, it was referred to a Joint Select Committee of Parliament. The Committee was comprised of thirty MPs from the Lok Sabha and fifteen from the Rajya Sabha, and was presided over by Satish Chandra, a Lok Sabha MP. Influential and weighty members of Parliament of varying shades of political ideologies, like Jyotirmoy Basu, Pilloo Mody, Indrajit Gupta, Y.B. Chavan and Manubhai Shah were a part of the forty-five-member august body that was assigned the task of vetting the draft Bill. The Joint Select Committee invited presentations from the public, government institutions and associations, like the Indian Banks' Association, Federation of Indian Chambers of Commerce and Industries, Associated Chambers of Commerce and Industries of India, Indo-American Chambers of Commerce, Travel Agents' Association, All-India Importers' Association and even the Reserve Bank Employees' Association. Several of the associations submitted memoranda, while representatives from several organizations appeared before the Committee to give oral evidence. The Exchange Control Department bore the brunt of the work in furnishing comments to the flow of memoranda that emanated from the Committee's deliberations. Deputy Governor Shiralkar was the seniormost Bank official to appear before the Committee to ensure the validity of the new legislation, while other Bank representatives fielded replies on the technical workability of the new legislation.

In the course of the oral evidence, several MPs voiced concerns and sought clarifications. Babu Bhai Chinoy wanted to know if the Reserve Bank

maintained any record of cases where Indians had taken up citizenship of foreign countries, got companies registered abroad and used such an avenue for foreign exchange manipulation. The Bank's response was that FERA was not applicable to Indians residing abroad and who had acquired citizenship of foreign countries. Jyotirmoy Basu queried whether the Bank maintained a detailed account of incoming remittances, particularly those pertaining to foreign missions and missionaries. It was explained that there were no restrictions under the exchange control regulations on inward remittances through banking channels and, according to the Bank's record, Rs 22–24 crore remittances received by Christian missions and missionaries. Another matter raised was how many cases had come to the notice of the Bank where exporting firms had not repatriated their earnings, misappropriated the foreign exchange and disappeared. The Bank procured the list from the Enforcement Directorate and furnished the same to the Joint Select Committee. Another MP wanted to know whether the Bank was armed with sufficient powers to prevent and control leakages of foreign exchange, and how these powers compared with those of other Central Banks. It was clarified that the Reserve Bank's statutory powers were basically of a regulatory nature, enabling it to lay down rules and tighten procedures with a view to minimize the scope for leakage of foreign exchange. On the other hand, the enforcement provisions of FERA, covering investigations, pursuit and punishment of breaches, were vested with the Enforcement Directorate functioning under the Cabinet Secretariat, while the checking of smuggled goods fell in the domain of the Customs Department. Since control over physical imports and exports of goods was exercised by the Import Trade Control authorities and the Customs Department, the Bank had no means of checking over-invoicing of imports or under-invoicing of exports. Likewise, authorized dealers (banks) who handled only trade documents were not equipped to control or detect leakage of foreign exchange on those counts. Clause 8(4) of the Bill, it was explained, would not help in preventing leakage of foreign exchange; it would only strengthen the hands of the Directorate of Enforcement in pursuit and punishment of such offences, after they were detected.

Through its sittings in Delhi, Calcutta and Bombay, the Joint Select Committee collected a pile of evidence from persons representing a vast array of organizations. At its twenty-first sitting on 15 February 1973, the Committee stated that the draft Bill required further amendments so as to widen its scope. It suggested plugging foreign exchange leakages through tourism, placing more checks on Indian joint ventures abroad, even takeover of foreign banks and a ban on the use of foreign brand names. Differ-

ences within the Committee, however, came in the way of a unanimous set of recommendations and sparked dissenting notes by Jyotirmoy Basu and Indrajit Gupta. Shorn of the radical recommendations, the Bill was a modest attempt at plugging the loopholes and, except for a couple of substantive changes from the earlier proposals submitted to the Cabinet, most of the other amendments were of a minor and technical nature.

On 5 March 1973, the Cabinet was informed by M.G. Kaul, Secretary, Department of Economic Affairs, that, in light of the evidence given and presentations made before the Joint Select Committee, some of the proposed amendments would have to be rewritten to make the legislative provisions more comprehensive. The major change related to clause 27, which proposed to control the entry of foreign companies into India for carrying on trading, commercial or industrial activity, or for setting up a branch or office for carrying such activities. The restrictions laid down in the clause were made applicable to companies in which non-resident holdings were 40 per cent or more. All such persons were required to obtain the permission of the Reserve Bank for continuing to carry on such activities.

However, considerable apprehension was expressed by the various Chambers of Commerce on how this clause would impact on industrial ventures set up with specific government approval under relevant statutes, such as the Industrial Regulation Act, 1951. Conferring such wide powers on the Reserve Bank to review past cases and to direct discontinuance of activities carried on with specific government approval, was seen as the surest way to restrain future foreign investment in highly sophisticated areas where foreign technology and participation were essential. The government recognized the need to soften the provision and amend it suitably to allay the genuine fears expressed by many. It was proposed to introduce an amendment to sub-clause 2 of clause 27, empowering the Bank to grant general or special exemption to a specific party. The thinking was that pre-1951 foreign investments that were operating without prior permission should be examined first and necessary discipline, like export obligations, slapped on them, and, thereafter, to review the approved investments to bring them in line with the framework of the guidelines. Likewise, in sub-clause (3) of clause 27, relating to non-resident holding of shares of 40 per cent or more, an amendment was proposed that would exempt holdings with specific approval under FERA, 1947. The majority in the Joint Select Committee viewed the provisions of clause 28 which sought to place an embargo on employment in India or abroad of a national of a foreign country, as going beyond the scope of the Bill. The clause was amended to confine the Bank's permission for future employment of foreigners/non-

residents to cases that entailed liability for remittance of foreign exchange arising from such employment. A new sub-clause 8 was added to clause 25 exercising some control over the setting up of joint ventures abroad and ensuring repatriation of dividends.

To assure the public that the Reserve Bank was not being given arbitrary powers, the Ministry of Law suggested incorporation of a provision in the draft Bill laying down the guidelines to be observed by the Bank in the exercise of its powers. The Legal Department of RBI was entrusted the job of formulating suitable guidelines, the crux of which was to ensure that all foreign exchange accruing to the country was accounted for and utilized to the best advantage of the country, and, in this context, to check attempts at evasion.

The Foreign Exchange Regulation Amendment Bill, 1973, was introduced by Finance Minister Y.B. Chavan in the Lok Sabha on 24 August 1973. Chavan's tactic was to present the main provisions for general discussion in the House, without any direct indication of his own party's clearly formed views. He relied on the strength, as he saw it, of the case for the specific proposals. And he succeeded in steering the legislation through, marginalizing the 'official connivance' lobby that vociferously attacked the operations of multinationals like ITC and Coca Cola, and harped on the inadequacy of the proposed legislation to curb exchange violations. Jyotirmoy Basu (CPI-M), who initiated the debate, described the Bill as an eyewash with too many loopholes, and accused the government of being hand-in-glove with those who violated foreign exchange regulations by under-invoicing and repatriating more than the permitted percentage of foreign companies' profits in India through dubious methods. The Parliament discussed the 81-section Bill for several days, so that there was no excuse for not understanding what was involved, at least in political terms. When the Bill was passed by the Lok Sabha it went to the Rajya Sabha, where it had an easy passage despite a last-ditch stand by the anti-foreign lobby. The Bill received the assent of the President of India on 19 September 1973 and was published in the government gazette the following day; a notification followed from the Ministry of Finance that the Foreign Exchange Regulation Act would come into force from 1 January 1974.

The Bill also received a hostile reception at the hands of the press. The *Times of India* editorial dubbed it a 'damp squib'. The assessment was that the new law would do little to curb the repatriation of excessive profits, dividends, royalties and technical fees by foreign companies operating in India. Accusing the government of not being serious in the matter and citing the Finance Minister's reluctance to accept Madhu Limaye's proposal

for banning the use of foreign brand names by Indian companies, the editorial was sceptical of the efficacy of the guidelines to be framed for the Reserve Bank to force foreign firms in low-technology industries to reduce their share of the market. The fixing of foreign non-resident holdings at 40 per cent was considered too liberal and on the high side to have any decisive impact on the expansion plans of foreign-controlled companies. The thrust of the editorial was to point an accusative finger at a whole gamut of foreign-controlled companies, branches, joint ventures, even foreign banks, who, in its view, would continue to enjoy far greater privileges than Indian firms.

The comments on the proposed legislation were an over-reaction. They were motivated by political prejudice rather than an analysis of the country's monetary and economic needs, and drew their inspiration from an out-dated vision of self-sufficiency and the capacity of regulators to tightly control every foreign exchange transaction.

In the intervening period between clearance of the Bill in Parliament and the new legislation coming into force, the Exchange Control Department of the RBI was preoccupied with giving detailed instructions to its regional offices regarding the administration of the Act. It pointed out that while several sections of FERA, 1947 were intact and were carried over to the new Act, there were a few that called for clarification. The regional offices were advised that in view of the provisions of Section 81(2) a of FERA, 1973, there would be no need to call back licences issued to authorized dealers and money changers under Section 3 of FERA, 1947. However, as and when the licences were due for renewal and applications made for the purpose, the Control must issue licences with reference to the new Act.

Likewise, the Directorate of Enforcement, through a circular, advised its offices that FERA, 1947 had been repealed and replaced by FERA, 1973; that the new Act would become operative from 1 January 1974; and that additional powers had been conferred on the central government and the Reserve Bank to regulate all foreign exchange transactions. It further clarified that rights and liabilities of a substantive nature, arising out of transactions prior to the promulgation of the new Act, would continue to be governed by the old Act, while matters relating to procedure would be governed by the new Act. While provisions of the new Act were to be invoked while calling for information, making searches or seizures, a person could not be punished for anything done prior to 1 January 1974 if it did not constitute an offence under the old Act. Similarly, pre-1974 contravention would attract penalties as per the old Act.

Soon after FERA, 1973 came into force, the government issued guide-

lines for dealing with applications under Section 29 of the Act. All branches of foreign companies and Indian companies that had more than 40 per cent interest were to obtain fresh permission to carry on their business, and had to comply with directions given by the Reserve Bank on foreign participation in capital structure, borrowings, foreign exchange payments relating to repatriation of capital. The new law required all such companies to bring down their non-resident shareholding to 40 per cent within two years. Following the debate in Parliament and the Finance Minister's promise to come up with guidelines that would assist the RBI in dealing with applications pertaining to Section 29, the government issued the same, according to which companies engaged in basic and core industries, or export-oriented industry (where exports were 60 per cent or more of total production), or companies engaged in manufacturing activities using sophisticated technology or running tea plantations would be allowed to carry on business with resident interest up to 74 per cent. For other activities, such as internal trading and commercial activities, construction and consultancy work, foreign holdings should not exceed 40 per cent. In exceptional cases, where units had developed expertise or distribution network facilities that were not available indigenously and were contributing significantly to exports, foreign holdings up to 74 per cent were allowed, depending on the merits of each case. For the Control, efficient administration of the guidelines had the effect of increasing rather than decreasing work.

It is indeed a coincidence that both FERA, 1947 and FERA, 1973 had a life-span of twenty-six years each. Just as FERA, 1947 was replaced by FERA, 1973, FERA, 1973 was replaced by FEMA, 1999. A vital difference between the 1947 and 1973 Acts was that, post independence, till 1972, the work of the Control had been mainly negative and concerned with preventing any expenditure of foreign exchange that was not immediately necessary. With the passing of FERA, 1973, the work of the Control took a different turn—it became more positive and selective. It needed to closely align with government policy, be it in development of exports, oil, travel, foreign investment, or foreign collaboration, to name but a few. In all these cases the foreign exchange factor loomed large, and they had to be handled expeditiously and in better perspective; this called for more coordination between the Control staff and the government, and much more interaction between the two. With the adoption of a holistic approach, a tighter regime of exchange control became inevitable, and the period after 1973 till liberalization in 1999 may be characterized as 'savagely' restrictive, with many more clients knocking on the Control's doors for clearances.



Long before the liberalization phase of the 1990s, as early as in 1982, the then RBI Governor recognized the essentially uneasy relationship between the Control and India's foreign trade efforts, and the need for another searching examination of its work. Under the terms of the Governor's memorandum dated 23 November 1982, the Reserve Bank set up an Expert Committee under the chairmanship of M.S. Patwardhan, Managing Director, National Organic Chemical Industries, to review the exchange control regulations relating to the export and import of goods and services mainly from the user's point of view, and to suggest measures for rationalization and simplification of regulations, procedures and practices. Members of the Expert Committee were drawn from private industry, the Indian engineering industry, two commercial banks, the Export-Import Bank of India, the Ministries of Finance and Commerce, and the Reserve Bank. In his address to the Committee's inaugural session on 10 December 1982, Governor Patel was at pains to explain the reasons behind the decision to appoint the Expert Committee and said, exchange control was 'a dynamic subject and its policies and procedures needed to be responsive to changes in a variety of external factors'. No doubt, the policies and procedures were subjected to constant departmental studies and reviews, but such internal studies and reviews tended to suffer from limitations, for, among the authorities responsible for administration of controls, there was a natural tendency to eschew drastic changes and to show a preference for status quo. Since the Department of Exchange Control was a service-oriented department, the Governor was keen on giving it a 'user-friendly' image, not one that appeared arbitrary and tyrannous. He was aware that foreign exchange control was bound to seem intrusive to those who were required to abide by the regulations, and felt there was good scope for simplifying and rationalizing the various procedures relating to imports and exports and for further delegation of powers to authorized dealers as well as decentralization of work within the Bank. This, then, was the rationale for setting up a broad-based Committee of experts. Although the findings and recommendations of the Committee fall outside the scope of this volume, it can be said that it set exchange control on the road to greater exposure to international banking practices, sharpening the skills of the personnel of the department through intensive training and adopting a more flexible and need-oriented approach in the opening of new Exchange Control offices. But the process of dismantling controls was nowhere in sight.



## HIGHLIGHTS OF EXCHANGE CONTROL POLICIES

This section traces the direction in which exchange control policy, particularly with respect to mobilization of non-resident Indian funds, was shaped and reshaped to meet the challenges of development and growth of the economy. In the post-rupee devaluation period (1967 to 1970), there was some improvement in India's external payments position but overall it remained tenuous with the foreign exchange reserve level hovering below a billion dollars. The rise in reserves in 1967-68 was partly due to an improvement in exports but mainly due to the continued shortfall in payments for imports financed by authorized dealers. The difficulties faced by the dollar and the pound sterling also contributed to the speeding up of export receipts but this favourable turn in the lead and lags, as pointed out by the Reserve Bank, was not expected to continue for long. At the then prevailing exchange rate, India's cost structure compared favourably with that of its major trading partners. Of course, much of the inflationary pressure had been repressed rather than removed; continuing to hold the line against inflation was the Bank's main policy plank in the post-devaluation period.

In this period the Reserve Bank's balance of payments division rapidly became engaged in work relating to exchange control on behalf of both the RBI and the government. It compiled a statistical commentary on gold, foreign exchange and major components of balance of payments like exports and invisibles, which, together with other material available, enabled the Exchange Control Department to identify the areas that needed liberalization or additional tightening. Area-wise forecasts prepared by the division were also of vital importance in the formulation of exchange policy.

The comparatively modest level of foreign exchange reserves acted as a brake on liberalization of the exchange control regime. Despite this limitation, every effort was made, through appropriate policy liberalization, to raise larger export and invisible receipts. In order to encourage exploration of export markets, an export market development allowance was proposed to be granted to tax payers other than foreign companies, at the rate of one-third of the revenue expenditure incurred for the purpose. The government also liberalized the rules for blanket release of exchange to exporters: the minimum export performance in the preceding year was lowered to Rs 25 lakh for exporters of traditional goods and Rs 5 lakh for non-traditional export items, as against the earlier requirement of Rs 1 crore for tea and jute goods exports, Rs 20 lakh for non-traditional items and Rs 50 lakh for other items. Exporting firms that were registered as export

houses with Government of India were made eligible for grant of a blanket exchange permit, irrespective of their past performance. In view of the difficulties experienced by exporters in raising funds locally for export financing, permission was accorded to receive advance remittances from overseas buyers, provided the rate of interest did not exceed 8 per cent and shipments were effected within a year of the advance. The liberalized scheme was also made applicable for purposes such as market studies and marketing research, advertisements abroad, participation in trade fairs, collection of samples, and technical information relating to export products and commodities.

Although the thrust of the control policy was in the direction of liberalization, overall it entailed micro-monitoring of export receipts. To boost exports of technical services and know-now, the budget of 1968–69 came up with income tax concessions for the entire income earned by Indian companies in the form of dividends, and for royalties and fees that were earned through the supply of technical know-how or services rendered to foreign countries. These measures were meant to promote exports and soften the rigours of a draconian system. The earliest recorded communication of how the Reserve Bank viewed the edifice of control was a letter written by Governor Jha in mid-1968 to I.G. Patel, in which he gave the reason why the machinery of exercising control worked so slowly. According to Jha, the rules were very complicated and so, at the technical level, in an attempt to plug all loopholes, too many tests and conditions were imposed, each of which could be justified on merits and could only be relaxed on wider considerations of administration and policy. This was a fact that could not be denied but then in the context of the development needs of the economy, wholesale modification and easing of rules were considered both difficult and impractical.

Around this time, the Finance Ministry turned its attention towards attracting investments by non-residents of Indian origin. A beginning was made in May 1968, when it was decided to permit withdrawals from the National Defence Remittance Scheme (NDRs). It will be recalled that in the wake of the India-Pakistan war of 1965, the government had crafted this scheme to attract inward remittances of non-residents in convertible currencies and Rs 71 crore were garnered under the scheme. The rupee proceeds of inward remittances received under the NDRs were held as deposit accounts designated as NDRs Special Account. In May 1968, relaxations were made for withdrawals from the NDRs Special Accounts, for payments to close relatives or dependents. Withdrawals were also permitted for meeting the expenses of the account-holder and his family during visits to

India, and a sum of Rs 20,000 was allowed for meeting marriage expenses within the family. The withdrawal amounts permitted were neither very liberal nor indicative of the undue leniency with which exchange regulations were devised and enforced. From time to time, the quantum of withdrawal amounts were raised but a measure of hesitancy was evident in going the full way. For instance, investment in plantations or for purchase of immovable property through withdrawals from NDRs Special Accounts was not permitted.<sup>3</sup>

The first breakthrough in allowing investments of NDRs Special Accounts in fixed deposits or Government of India securities or UTI units or shares of Indian public limited companies came in May 1968. But the investments were made subject to conditionalities: investment was allowed only in an industrial concern; profits earned could not be repatriated abroad; the earnings from such investment would be credited to the NDRs Special Account; in the case of investment in a private limited company, the non-resident would progressively associate resident Indian participation, at least up to 49 per cent, over a five-year time frame. Towards the close of 1968,<sup>4</sup> further relaxation was offered to non-resident investments by throwing open investments in trade or business. Hitherto, investments were confined to companies engaged in industry and not to trade or business. This stipulation was withdrawn; however, the requirements of non-repatriation of dividends and crediting the sale proceeds of the investment to the NDRs Special Account were retained. Both these were intended to see that non-resident Indians do not convert their rupees into foreign currency in the black market or, conversely, did not sell their foreign exchange earnings in the black market against credit in rupees. Later in the year, it was decided to allow investments by non-resident Indians in partnership and proprietary concerns, which was earlier prohibited. Once again, there was a proviso that profits and sale proceeds were to be credited to the non-resident blocked account of the investor till such time as the non-resident took up Indian citizenship.

In Governor Jha's view, this aspect of exchange control could, with suitable instructions, be delegated to authorized dealers, thereby reducing such references to the Reserve Bank to the minimum. Also, references to the Bank should emanate from the authorized dealer and not individuals. Jha had a distaste for operational procedures of an intrusive kind. At the

<sup>3</sup> See ECD circular No. 27 of 9 March 1968.

<sup>4</sup> ECD circular No. 106 of 24 December 1968.

prodding of the Bank, the government, with the approval of Finance Minister Morarji Desai, delegated the maximum possible powers to authorized dealers to deal with such requests on their own. Around the same time, with a view to find suitable outlets for the blocked rupee holdings of non-resident Indians, they were encouraged to book their passages against debits to their non-resident rupee accounts. This concession was allowed only for sectors where Air India operated and not for other sectors. Other token concessions were granting permission to take personal effects of a value not exceeding Rs 500 per family on production of a certificate from the authorized dealer, and automatic drawals from their bank accounts of Rs 200 per week or up to Rs 10,000 per annum.

In retrospect, it can be said that there were several relaxations to attract non-resident Indian funds but they were hamstrung by an equally large number of labour-intensive micro-regulations. In September, in the spirit of Jha's suggestions, and with a view to minimizing inconvenience and delays, further powers were delegated to the authorized dealers for undertaking transactions such as payment of membership fees, meeting legal expenses related to dishonoured export bills, university admission fees, and grant of loans or overdrafts to non-resident constituents of Indian origin, without the approval of the Reserve Bank. But certain specified ceilings were prescribed, beyond which RBI's intervention became necessary. The Governor directed the Control to embark on a policy of simplification to exercise judgement rather than strive for the government's approval on big and small matters. This was a significant policy initiative to keep the administration of controls within sensible bounds.

In mid-June 1972, in order to entice Indians residing abroad to return to India to settle down and open their own business or small-scale industries, exemption was granted for a period of three years from their date of return from the requirement of surrender of foreign exchange. What was more, surrendered foreign exchange would qualify for retransfer within the period of three years of their arrival; in other words, if adjustment proved difficult, they had the option of going back without losing control of their foreign funds. Initially, there was considerable difficulty in implementing the scheme. Through a press note, it was clarified that approval for reconversion of rupee funds representing the net amount of foreign exchange brought in by the account-holder would be decided by the Reserve Bank on the merit of each case, which would be decided on the basis of the guidelines publicized in the press release of 12 September 1975. The press release was followed by detailed operative instructions issued to the regional units of the Exchange Control. In May 1976, the facility was extended to Indians

holding foreign passports and to holders of FCNR accounts. Despite the assurances, fears were expressed regarding reconversion; K.B. Lal, India's Ambassador to Hongkong, in a letter to Deputy Governor Luther, said that the assurance on reconversion given by the Bank was not adequate. Peeved at the communication received from Lal, Luther shot back that he failed to understand how the reconversion assurance of the balance held in FCNR accounts was inadequate, it was given by the Bank in writing on the duplicate copy of the application.

Overall, the major relaxations in the operation of ordinary non-resident accounts came slowly. The next major change after 1968 came in March 1976, allowing authorized dealers to credit rentals received on flats and houses owned by non-resident Indians to their non-resident ordinary accounts without limit. In 1978 there were further enhancements in the payment limits for family expenses and allowances for relatives and dependents. In October 1980, the controller, T.N. Iyer, felt there was need to review the implementation of the non-resident ordinary accounts to see if further relaxations were warranted. He felt the time was opportune to free debits to ordinary non-resident accounts from all restrictions, barring payments for international passages and for investments made in India. The proposal, in principle, was cleared by Deputy Governor Nangia, with a proviso to go slow on the changes. The liberalized scheme was put into operation in 1981,<sup>5</sup> giving authorized dealers the latitude to debit all payments other than for investments in India and booking of international passages. Debits exceeding Rs 10,000 had to be reported to the Bank; however, payments towards approved investments, such as units of UTI, National Savings Certificates and central and state government securities, could be made freely. For loans and overdrafts against non resident rupee accounts, prior approval of the Bank was required, as before.

The proposal for opening of bank accounts in foreign currencies in India by overseas Indians was forwarded by K.C. Pant, Minister of State for Finance, to Governor Jha, in 1968. The proposal was initiated by the chairman of United Commercial Bank, Hongkong. The RBI Governor was not enamoured by the proposal; after careful consideration, he concluded that there were no special benefits that would flow from such an arrangement. Jha was at a loss to fathom how and why overseas Indians would want to maintain a foreign currency account with an Indian bank, when they could do so more easily by banking with an overseas branch of an Indian bank. If

<sup>5</sup> Vide circular No. 6 dated 16 March 1981.

banks in India accepted deposits denominated in foreign currencies, they would not be in a position to lend the foreign currency to any borrower in India, except to those to whom a foreign exchange loan was approved. Even assuming that the banks decided to lend for short periods, it would mean converting the foreign exchange into rupees. And what was the guarantee that it would be able to reconvert the rupees into foreign exchange without an exchange loss? All in all, the Governor saw no clear advantage; if anything, it would be a clumsy and cumbersome arrangement of little material value.

The Governor conveyed his reservations to the Minister. The latter, while accepting the Bank's reasoning, instructed Y.T. Shah, Joint Secretary, Ministry of Finance, to advise the RBI that banks should be permitted to open external rupee accounts, provided these were credited with inward remittances and on the understanding that funds lying in such external accounts would be given automatic repatriation facilities. To remove the perception of excessive formality and undue delays, the Minister was eager to give publicity to this aspect. But the Bank's official hierarchy had the apprehension that, should the flow of funds via the external rupee account route assume large dimensions, it could pose serious strains on the vulnerable balance of payments position. By way of abundant caution, the Exchange Control was asked to monitor the position and it was decided that if the total in all such external rupee accounts exceeded Rs 10 crore, discussions would be held between the Bank and the government to decide on the future course of action.

In August 1973, T.R. Varadhachary, Managing Director of State Bank of India, during a visit to the Beirut branch, was surprised to find advertisements in the Middle East papers by Pakistani banks soliciting foreign currency deposits. He requested the Reserve Bank to consider enhancing the popularity of the external deposits by allowing deposits in foreign currencies and accepting the exchange risk. His evaluation was that the cost of funds raised would be cheaper than a straight borrowing in the Eurodollar market.

The Reserve Bank examined Varadachary's proposal with an open mind. As details of the Pakistani scheme were not available, the Control undertook a study of the working of the Indian non-resident external accounts, to find that the scheme was not very popular; there were barely 9,718 such accounts, whose aggregate balance stood at Rs 14 crore spread over 87 countries. Another disturbing aspect was that, considering the sizeable Indian population residing in the US and Canada, the total volume of non-resident external (NRE) deposits from those countries was extremely insignificant.

Obviously, the incentives of tax exemption and repatriation had not proved attractive enough to entice an inward flow. The conclusion that emerged from the examination was: since the deposits were denominated in Indian rupees, the depositors were exposed to the risk of capital depreciation in the event of devaluation of the rupee or revaluation of foreign currencies, and this inhibited the transfer of savings of non-residents to India.

Recognizing that the existing NRE scheme had not yielded the desired results, the Control turned its attention to issues that would need to be resolved if external accounts were to be maintained in foreign currencies. The modalities fleshed out were as follows. The Reserve Bank would retain the foreign currency needed for its immediate requirement in its accounts with banks abroad and would sell the remaining foreign currency. The sale of foreign currency would affect its exchange position and this would call for squaring of the operations. In the event of an exchange rate change of the rupee or of the foreign currency, the Bank would have to book the exchange gain or loss depending on its overbought/oversold position. Servicing the foreign currency deposit would entail a higher cost but this could be ignored in the interest of additional inflow of foreign exchange. The office note also suggested that foreign currency accounts be denominated in fourteen currencies under the category of the external account group, and depositors could remit in any of the prescribed currencies. A further suggestion was that foreign currency deposits should accrue to the general reserves and authorized dealers should not be allowed to retain these funds in their normal foreign currency balances for meeting their day-to-day expenses. In the event of a non-resident Indian wanting to utilize a part of the deposits for local disbursements, the banks should purchase the foreign currency amount at the buying rate ruling on the purchase date. Depositors were required to draw foreign currency cheques in favour of the banks with instructions to pay the beneficiaries. This was deemed necessary to avoid misuse of funds.

On an earlier occasion, when the Bank had examined the proposal of allowing the opening of a non-resident account, warning had been given that the difficulties in doing so were real and should not be lost sight of. Following a re-examination of the pros and cons of maintaining a non-resident external account, the Control indicated it was not in favour. Deputy Governor Shiralkar endorsed line and wrote to Narasimham, Additional Secretary, Department of Economic Affairs, on 13 November 1973, that considering the real difficulties faced in administering such a scheme, the Bank was not inclined to view the proposal favourably. Once again the Bank shied away from finding an answer.

But the government remained adamant. Its over-riding concern was the sharp fall anticipated in foreign exchange reserves. The reduction in reserves to the near amber-light zone evoked the traditional anxiety. M.G. Kaul, Economic Secretary, in a letter to Governor Jagannathan dated 2 January 1974, wrote: 'in view of the pressure likely to develop on the balance of payments in the next few years all avenues need to be explored to attract foreign deposits including the exchange risk factor that had inhibited the inflow.' Government of India remained of the view that the exchange risk would have to be borne for the gain that would be derived from such deposits. Kaul wanted the Bank to once again examine the administrative feasibility of such a scheme and find alternative ways of overcoming them.

The Reserve Bank undertook a fresh evaluation. Ruling out Varadachary's proposal of permitting banks to accept foreign currency deposits and utilizing these funds abroad, the Bank pointed out that the same result could be achieved through borrowings in the Eurodollar market. Acceptance of short-term repatriable deposits from abroad with the value guaranteed in foreign currency was another method of borrowing. But then, it was essential to evaluate the cost of 'retail' and 'wholesale' borrowing, to decide where the special advantage lay. The difficulties of permitting piecemeal withdrawals through cheques were also considered to be cumbersome and impracticable. In short, the bottom line of the Bank's response was that operating such a scheme was not feasible.

In the Bank's judgement, the simplest course would be to go in for fixed deposits for specified periods and to make the deposits eligible for interest at the prevailing rates, which were attractive enough compared to the rates obtaining abroad. With interest rates ruling high in the UK, it was easy to see that persons of Indian origin residing there would not be lured to the Indian scheme. No doubt these deposits would have to be guaranteed for their value in terms of the foreign currencies involved. But the difficulty of announcing a guaranteed scheme was that the holders of accounts under the current non-resident external account scheme would demand similar guarantees, and if these were not conceded, they would repatriate the deposits, which were estimated at Rs 14 crore at end-March 1973. The quantum of deposits that would accrue under the reinforced guaranteed scheme was a matter of conjecture.

In the 1970s, the Bank was the main advisory body to the government on matters relating to foreign exchange but, in this matter of high policy, the Finance Ministry's voice was decisive. Discarding its reservations under pressure from the government, on 24 May 1975, Hazare, Deputy Governor, indicated to the government that the Bank was ready to introduce



the non-resident (external) account scheme in specified foreign currencies at marginally higher rates than those applicable to domestic deposits of corresponding maturities, and that a suitable scheme could be devised with appropriate safeguards.

Thus, on 1 November 1975, within a matter of six months, the modified FCNR scheme<sup>6</sup> became operative. Its highlights were: the exchange risk was eliminated; deposits, together with interest earned, were repatriable in foreign currencies; the income earned was tax-free; deposits could be opened in pound sterling or dollars. The earlier non-resident external accounts maintained in rupees were also covered by the new scheme. The maturity period was refixed from a minimum of one year to a maximum of five years, from 1 March 1976. Later, in mid-1979, the five-year cap was removed.

Despite detailed procedures spelt out by the Exchange Control through umpteen circulars, the scheme was not free from operational hassles. Complaints were lodged regarding the rate of exchange applied for conversion of the FCNR deposits by the authorized dealers. For instance, *Business Standard* reported that in the case of a non-resident who had returned to India prior to the maturity of the fixed deposit, the authorized dealer holding the deposit had redesignated the account as 'resident' and conversion of the deposit was made at the rate prevailing at the time of deposit and not on the interpretation given by the Control. The Control advised the dealer that FCNR accounts should be converted into rupees at the TT buying rate on the date the account was actually converted into rupees, irrespective of the date of arrival of the non-resident in India. Such procedural wrangles were not uncommon, and sorting them out became part of the working of the Control. Likewise, misgivings continued to dominate the minds of non-resident Indians regarding the guarantee of repatriation. These were unfounded but, motivated by the large Indian populations residing in Hongkong, Singapore and the Middle East, proposals poured in to consider various options to make the scheme more attractive and flexible. The Bank examined these but conventional wisdom prevented it from accepting them.

Another attractive feature of the NRE account was that the income earned on it was exempt from tax.<sup>7</sup> On 10 February 1970, rules governing the NRE

<sup>6</sup> AD circular No. 82 dated 6 October 1975 outlined the modified scheme and procedures to be followed by authorized dealers.

<sup>7</sup> In terms of an amendment to clause 4A of Section 10 of the Income Tax Act, 1961, the Finance Act of 1968 exempted from tax any interest received on moneys standing to the credit of Non Resident External Account—AD circular No. 15 of 16 April 1970.

account were codified and, as a follow-up measure, the Reserve Bank issued an AD circular on 16 April, permitting authorized dealers, without prior permission of the Bank, to open such accounts. However, it was not till 1978 that permission was given to the dealers to open external accounts against tender of foreign currency notes and coins and travellers' cheques by eligible persons during their temporary visits to India.

The need for moving away from the excessively detailed regulations that characterized the Control in the early 1970s was recognized, and relaxations in the rules governing NRE accounts was a beginning in that direction. No doubt, the labyrinth of controls were odious to an entrant but then, in a tightly controlled and planned economy, where the ideological fervour for Indian-style perestroika was dominant, relaxations were slow in coming. In keeping with the stress on the objective of self-reliance, alongside some of the relaxations, the tempo of inspections was stepped up. To illustrate, in the course of inspections of authorized dealers, it was observed by the Control that external accounts were opened and credited with large rupee funds in cash that were claimed to be of external origin. The Reserve Bank was clearly uneasy about these cash credits in rupees. In mid-July 1980, it reiterated that these dealers had no authority to credit the external accounts with such rupee funds and the Control's regional offices were instructed to caution banks not to encourage such rupee credits. Between 1978 and 1980, a spate of circulars pertaining to NRE accounts were issued, which gave the impression that while seeking to enlarge the sphere of operations of this category, there was simultaneously a move to micro-manage the accounts.

To begin with, both NRE and FCNR accounts were on par with interest rates on domestic deposits. But in mid-1977, it was decided to lower the rates on NRE deposits while retaining the rates on FCNR deposits, pending a detailed review. All along, the Reserve Bank viewed the FCNR scheme basically as a high-cost borrowing. Karan Sharda, an MP, had also suggested that considering the rising trend for foreign exchange reserves and low yields thereon, there was little justification of encouraging inflows into FCNR accounts by offering higher rates and exchange risk protection. The Bank examined the issue and found that the incentives offered were attractive and that this had encouraged the inflow. However, Governor Narasimham realized that abolishing the FCNR scheme *in toto* could have undesirable and far-reaching repercussions on the overall inflow of funds from non-resident Indians, and, in November 1977, decided against abolition. While retaining the scheme, he got rid of some of its attractive

features, shortened the tenure of FCNR deposits from 61 to 37 months,<sup>8</sup> enhanced the lock-in period for the deposits and aligned the interest rates on FCNR deposits with those applicable to NRE deposits.

Surprisingly, the government remained of the view that the favourable foreign exchange reserves position as compared to 1975 justified lowering the interest rates of FCNR deposits to even below those payable on NRE accounts. So, in March 1978, marginal downward modification was effected; but, in March 1982, with an unfavourable swing in the reserves position, the interest rates on FCNR term deposits were hiked 2 percentage points above the rates fixed for domestic deposits.

In 1981, with a weakening of the external payments position, the Reserve Bank was constrained to warn authorized dealers to be vigilant with regard to credits put through the NRE accounts, and advised that no third party credits should be allowed as that could facilitate unscrupulous elements to acquire travellers' cheques and foreign currency in India with a view to transferring rupee funds out of India. Acceptance of travellers' cheques with third party endorsements was not to be entertained, and frequent credits and debits to these accounts were to be handled with extra care. Also, transfer of funds from one NRE account to another was against the rules. The Bank records show that requests even for nominal amounts of transfer were summarily rejected.

Likewise, joint NRE accounts where one party was a resident Indian were not legally allowed. In 1975, the central office of the Exchange Control discovered that one of its regional offices was giving approvals freely for such joint accounts; the concerned regional office was reprimanded and, on 24 May 1975, a clarificatory circular was issued that the NRE Rules of 1970 contained no provision enabling a resident to hold an external account jointly with a non-resident. Regional offices were instructed to forthwith cancel all approvals for external joint accounts with residents. However, for operational convenience, NRE account-holders could execute a power of attorney in favour of residents to operate such accounts, which would imply that the resident was acting merely as an agent of the account-holder.

Despite the clarification, suggestions were made from time to time for opening NRE accounts jointly with residents in India, but the rule-bound Reserve Bank refused to budge from its stated position, as in the case of an Indian national residing in the UAE. This individual had requested permi-

<sup>8</sup> Reducing the tenure of the deposit meant the effective cost of servicing the deposit came down from 10 per cent to 8 per cent.

ssion to open an NRE account with the State Bank of India in the name of a family trust in Dubai and to appoint SBI as a co-trustee to manage the trust on behalf of his family as his wife would have difficulties in doing so. SBI indicated its willingness to manage the trust. The income of the trust was to be utilized for the beneficiaries as and when needed, and for their visits to India. The Exchange Control examined the case but rejected it on the ground that trust companies formed abroad by non-residents were not beneficial to the country.