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Mr. D. Swarup,
Member Convener,
Financial Sector Legislative Reforms Commission,
New Delhi.

18th January, 2013.

Dear Sir,

Our submissions on – Capital Controls

I. Preface & Goals:

1. Preface:

We agree with the Approach Paper that a good law is defined by Clarity of **Goals**, **Empowerment** of the Regulators coupled with independence from politicians and holding them **Accountable**. In this submission, we examine the present system focusing on Foreign exchange; and then suggest alternative.

Entire scheme of control of foreign exchange was administered – not by one law. There was a whole system of several laws & several regulators. We may consider the system as a whole.

In the past, the focus was almost entirely on Indian residents – forcing them to retain all their assets in India, preventing any outward flow & forcing all inward flows. Foreigners were simply prohibited from investing in India. So regulating their investments was not an issue. (The predecessor to FIPB would consider a few applications in a year.)

May we call the time periods as:

(i) Years 1947 to 1991 as “Licence & Control Raj”.

(ii) Years 1991 to 2013 as “Transitory Period”.

(iii) The future as a period of Economic Independence for India.

2. Goals:

We submit the following as the goals for the new Capital Control System or **“Capital Management System”.**

2.1 Controlling continuous trade deficit and achieving **trade surplus** or trade balance. For this purpose, converting the present – “**Adverse Terms of Trade**” into “Favourable Terms of Trade”.

2.2 Maintenance of Internal & External **Value of Indian Rupee**.

2.3 Expanding the **focus** from Indian residents to **global capital** & global risks.

2.4 Controlling **Flights of Capital** for ensuring economic & political safety & independence. Building adequate capabilities to meet with deliberately caused flights of capital.

2.5 Changing the enforcement of law by "**terror for all"** to: "**Incentive for all &** terror for the serious & deliberate offenders".

2.5.2 Attracting foreign capital and at the same time realising that it is not an unmixed blessing. Identifying the risks & managing the risks.

2.5.3 Separating the serious offenders from minor offenders and treating the two separately.

2.6 Having an effective, fair, democratic & independent **administration**.

Capital Controls are "regulations" not revenue laws. Hence it is practical to incentivise rather than terrorise.

With these goals in consideration, we may examine the past & present; and suggest alternative – where necessary, for the future. Our submissions are presented separately for Legislative front – paragraphs 3 & 4 and Policy front – paragraphs 5 to .

II. Legislative Aspects:

3. Capital Controls in the Control Raj:

3.1 It was an **all encompassing system** to ensure that Indian wealth remained in India and outward flow of capital was prohibited. FERA, Customs control with stiff tariffs on imports, Import Licensing & Gold Control Act were administered with absolute authority by relevant regulators.

Government firmly believed that "All Indian wealth belongs to the Government & not to the wealth creator. We had Income-tax rate of 97.5%, wealth tax rate of 8% and Estate Duty rate of 85%. **Usurious rates.**

In the same manner, it was convinced that **foreign exchange** belongs to the Government & RBI; and not to the exchange earner. Equally usurious policy.

Entire system was against the **instinct of self preservation**. Hence no one wanted to comply with the law. Hence enforcement was based on terror.

Foreign capital was prohibited under the "East India Company Syndrome". So there was no detailed consideration of regulating the foreign capital. SEBI was not yet thought of.

3.2 This Control Raj **naturally failed**. Our GDP growth remained low. Hawala & Smuggling were common & hugely profitable. Some smugglers became more powerful & Influential than noted industrialists. Indian wealth continuously moved out & Indian Finance Minister observed annual ritual of begging before the "Aid India Consortium". Our foreign exchange reserves dipped below $ 1 billion & brought us to the brinks of external insolvency.

The Jolt of 1991 brought the Government to **liberalisation – partly.** On one hand there was considerable liberalisation making it unnecessary to have terror provisions of enforcement. But the terror part of the law continued. Law remained Ineffective against the powerful & a terror for the common man. This trend continues even today. One has to just look at the following facts: In **Jain Hawala Case**, Honourable Supreme Court could not bring to the books the offenders. It was not the failure of Supreme Court. It was the **failure of entire Control System.** Similar ineffectiveness continues in Hasan Ali Khan's case, HSBC list & Telgi's case.

If this ineffective terror system of controls continues, India is in for big danger. FSLRC has come not a moment too soon.

4. Transition Period:

4.1 Gold Control Act has been abolished. Estate duty has been abolished. Indian direct tax rate package is more reasonable than the rates package prevailing in countries like USA, UK, Germany, etc. Customs duty rates & Import licence controls have been brought down considerably. There are many other substantial liberalisations. Altogether, intrinsically, India offers a better investment opportunity than many countries around the world. Many Indian residents have brought back their black money held abroad even in absence of a voluntary disclosure scheme. Hawala market & smuggling have reduced significantly. There is an incentive to invest in India, bring back the money to India & not to send Indian money abroad. This massive advantage has happened because of liberalisation – and not because of strict or efficient administration.

This is the "Substance" part of the law.

4.2 However, **enforcement by terror** – part of the law has still remained as the **language of the law**. This is unnecessary today. All the laws need redrafting. A democratic country cannot run on terror as law. It is the norm in countries with which we do not want to be compared.

There will always be black sheep. We do need effective deterrent against them. Equally important is – separating the harmless **small offenders** from the potentially **dangerous large offenders**. For example, if someone evades income-tax of Rs. 10,000; or does not file a form under FEMA; or invests $ 2,000 without filing the LRS form under Liberalised Remittance Scheme – he is a small offender. He has to be dealt with differently from the giant offenders.

Specific – For all offences which are considered procedural or minor – the **Enforcement Directorate** should have no jurisdiction at all.

4.3 **Drafting Approach** – Even today the draftsman continuously thinks- how the Indian citizen will evade the law. All drafting is based on suspicion. It is difficult to find a single healthy law like the Indian Contract Act.

This suspicious approach in drafting as well as administration is significant under FEMA. Even if a liberalisation is given, it is with several conditions attached. Common man looks at the substantial liberalisation, does not understand the conditions & is then termed an offender. It is a paradox that RBI is the most efficient & clean institution, staffed by honest & decent officers. However, these decent men have still not come out of the Control Raj mindset. We can take illustrations of recent circulars and show the clear stamp of Control Raj mind set.

How do you change a Mindset?
We will not submit on this issue.

4.4 **Appeals:** Sound appellate procedure is a redressal against the injustice caused by mindset. A democratic principle is: Any human being can make an error. A person in authority – if he is unaccountable is more likely to make errors than a normal being.

At RBI, if an officer takes a decision, the common man has no appellate recourse. We submit that a sound appellate system should be introduced within RBI. Illustration – within the Income-tax department we have CIT (Appeals) and then Appellate Tribunal. A similar mechanism within RBI, independent of Government bureaucrats is necessary.

III. **Policy Aspects:**

In this part, we consider entire period from 1947 to 2013.

5. **Hawala:**

Indian Rupee has always been **fully convertible** on both capital & revenue accounts in Hawala market. The rich have transferred their funds in & out of the country at their sweet Will. FEMA is only harassment to the ordinary businessman. Why did Hawala succeed in India?

When a law and the system are directly contrary to the economic interest of the people; they will fail and cause several **vicious cycles**. System has to be such that the businessman has a vested interest in the growth & stability of Indian economy. Such a system will cause several **virtuous cycles**. This hypothesis has been proved by good liberalisation of Indian economy since 1991.

6. **Rupee Value:**

It should be the Primary Goal of Ministry of Finance (MOF) & RBI to preserve the value of the Rupee. Both the Regulators have ignored following: **External value** of Rupee & **Internal value** of Rupee are **two sides of the same coin**. If there is inflation (fall in internal value); there is bound to be depreciation of rupee value on the external front. Inflation is the **cause** & Rupee depreciation is the **effect.**

In the years 2011 & 2012, Rupee depreciated from Rs. 45/ $ to Rs. 56 / $. This caused huge increase in the cost of imported crude oil, increase in transport costs & general inflation all over the country's economy. Rupee depreciation was the cause & inflation was the effect.

"**Cause, effect, cause" become a vicious cycle** – continuously taking down the value of Rupee.

Both regulators are considering external and internal value of Rupee as two separate matters. They are trying to manage these values separately and failing.

If maintenance of Rupee value was the primary goal under FEMA for both regulators; they have failed. But it is not their goal if we go by the preamble to FEMA.

7. **Loss for the Country:**

In the year 1947, 10 grammes of gold cost Rs. 88. Today it costs Rs. 30,000. Which means Rupee has depreciated to 1/340 (one upon three hundred & fortieth) of its value. (Percentages lose all their meanings at this scale.)

It is recognised by U.N. and economists that market value of the Rupee is one third of its purchasing power value (PPP).

This means **Adverse Terms of Trade** for India.

This means **Continuous Trade Deficit for India** – since 1947 to 2012.

We repeat: Under valuation of Rupee is the Cause for Trade deficit – just as Trade deficit is the cause for depreciation of Rupee. (This issue needs in depth discussion. We know the objections that regulators & economists take to this submission.)

The Goal under the new law on Foreign Exchange should be: It will be the responsibility of both the regulators to reverse the **Adverse Terms of Trade** & stop abundant losses that Indian economy is suffering today.

8. **Investors' Loss:**

Continuously **falling Rupee** also means that everyone who invests in India is a loser. Who are the investors in India?

8.1 Biggest investors in India are the **Indian Residents**. Our existing Indian wealth may be $/Rs. X trillions. Our annual savings are $ 400 billions or more. Nobody pays attention to Indian Residents and we look for all the ways to attract FII & FDI.

Rupee continuously depreciates in India & outside India. We have **prohibited the Residents from investing abroad**. And then we assume, this part of the total capital is taken care of. Kings used to force free labour. GOI forces free capital.

8.2 We have **negative real rate of interest**. While the person who saves in Indian Rupee suffers a real loss of interest, we tax him. Finance Ministry is shouting again & again to reduce the interest.

Then they wonder why Indians are **importing gold**!

In our submission, import of gold means – Indian saver says: "We have no faith in this Government's Rupee. We are sending our money out of India and replacing it with an international currency."

Any restrictions on import of gold will only escalate smuggling with its inherent problems. The only way gold import can be reduced is: MOF & RBI have to stabilise internal & external value of Rupee.

Look after Indian Residents if we want Indian Capital Controls to succeed.

8.3 How USA can get loans @ 0%?

In USA the Government is the **biggest borrower**. And it does not borrow from the U.S. public – which does not save. USA as a whole is borrowing from rest of the world. It is in their vested interest to force the lenders a "NIL" rate of interest.

Our Central Government tells us to reduce rate of interest. They do not realise the dangers of antagonising Indian saver. The dangers are: Indian saver runs away from Rupee. He either sends his **capital abroad**, or buys **gold** or invests in real estate. Indian scarce capital going away from Indian industry & business. And then we go abroad for loans & investments.

USA forces loans from the world by dollarisation of global trade; manipulating exchange rates to force Central Banks of the world in buying more of $ (treasury bonds etc.) and a package of equally potent weapons. India has no such weapons available to it. We must stop frightening investors & savers and stop depreciation of Rupee – internal & external.

8.4 NRIs:

Next investors are NRIs. Enough has been debated on the issue. We submit: NRIs are an important source of foreign exchange. We must give them a priority over foreign investors until we can have a positive trade balance.

8.5 FDI:

This is important. We are giving them enough attention under the law. However, when Rupee depreciated from Rs. 45 to Rs. 55 per $, they have suffered a loss of 22% in less than one year. This is loss on capital, not revenue. Which investor will take this in his stride?

Our submission: GOI and RBI must together ensure stability in Rupee value. This will resolve half the problems.

9. Huge Challenges:

We need to shift our focus from ordinary Indian businessmen to the Global Risks. The scene and the gravity of risks are completely different.

9.1 **USA & Europe** are in **serious financial and economic crisis.** We believe, their crisis can get much worse before the economies stabilise. Some of these countries are known for:

(i) **Exporting their inflation** & their problems to others.

(ii) Achieving their **political objectives** through economic policies.

Global institutions (U.N., IMF, & World Bank) and the cartel of specific western bankers) work together, with these Governments to achieve their objectives.

9.2 Some illustrations are:

(i) President Reagan started the **Star Wars** programme in the year 1983 with a specific purpose. The target was achieved in 1992 when **U.S.S.R. collapsed**, broke into ten different countries & lost the Super Power No. 2 status. USA became the only Super Power in the world without losing a single soldier. This incident proved that a strategic **Economic War can be more destructive than a traditional war.**

(ii) **South East Asian Crisis** in the year 1997 saw- (a) Over throw of President Suharto from Indonesia; (b) "Liberalisation" of East Timor by U.N. military; (c) All South East Asian countries that had started their international business in Yen instead of U.S. $; went insolvent. After stabilisation, they had to start international trade in U.S. $.

(iii) **Japanese Yen** fluctuated – Per U.S. $ - from 4 in 1944 to 360 in 1945 and then to 200 to 100 etc. Each time Japan changed the value of Yen to suit American economic interest.

Each of the above stories can take up full essays. Gold Carry Trade, Dollarisation of global trade, Currency War, Attack on Euro; & so on -- there are too many stories.

9.3 The core issue for consideration is:

The cartel is in crisis. Cartel can & is known to have caused serious damages to its friends & enemies in pursuit of their own economic interest. They have caused in the past and can cause serious losses to Indian economy. Indian regulators have to be prepared for these huge challenges.

The new Capital Controls may have as its Goal, building capability to meet an all out global crisis.

9.4 In our submission, RBI is engrossed in too many petty matters. Where is the time for being prepared for challenges imposed by these powerful cartels? $ 300 Bn. would be small cash for the **international cartels**. With **unlimited leverage** at their command, they can implement serious schemes.

In the past – under FERA, the regulators could say, "We have closed the doors and outside crises can't damage us". Today we are part of the global economic matrix. We can't close the doors. We are exposed. The big danger is from **FIIs**. Government of India is keen on giving tax concessions & other liberties to FIIs. RBI is involved in petty procedures.

10. FIIs:

We need to realise that the FIIs are not investors. They are speculators with a keen desire to maximise their profits – even if that means causing flights of capital. They have best brains and other resources to lobby their case; and media to propagate their case.

They are a danger – not only to US economy but to our economy also. RBI and SEBI together have to strictly regulate all their actions.

Simple analysis of **US & European crisis** is: the greedy financial institutions and bankers over leveraged and did everything wrong. Before doing this (during Reagan's presidency and thereafter) **they got the laws changed to make all their actions legal.**

Now they have targeted India. They would like Indian laws to be changed to suit their needs.

Our submission:

Anyone who wants to speculate on **foreign exchange** must be asked to comply with **stiff margin** requirements fixed by RBI. Speculation in all other markets also must be enforced stiff margins by the concerned regulators. No **hedging** should be permitted in absence of an **underlying actual business of equivalent value**.

And it is clear that the Government has repeatedly succumbed to the lobbying by specific vested interests. Hence, for control over FIIs; RBI and SEBI must be granted complete independence from Government.

11. Further Realisations: We may realise that:

(i) The potential for threat of flight of capital is from certain foreign Governments & cartels.

(ii) **Indian exporter** is not the risk for flight of capital. Our total exports are tiny as compared to the fire power of the cartels.

(iii) In any case, Hawala trade flourished till 1991. Thereafter it has come down only because of liberalisation & not due to any effective administration of law.

We will succeed in the future Capital Management System only if we can design such a system where the Indian resident has a vested interest in achieving these goals. No regulator will succeed by fighting with entire Indian business. By "business" we do not mean the vocal lobbyists who get laws and policies modified to suit their greed. By "business" we mean entire business community of India and all the savers of India.

12. There are matters which need to be decided by political Governments. Then there are extremely serious matters which go to the core of economic safety of the country. Like the goals stated in paragraph 2 above. They are too serious matters to be left to the Government – which is ruled by politicians – who are affected by lobbies.

We need constitutional authorities who are completely independent of any influences. In Germany, if the Finance Minister & Governor of Bundes Bank have differences, generally, the Minister may resign. This level of independence for RBI and SEBI has to be established in India.

With the independence, there will be–the goals. And regular measurement of achievement of goal. And accountability. It was said that in New Zealand, if the inflation crossed 2%, Central Bank Governor would lose his job. However, Indian economy is much larger & more complex. When a goal is responsibility of several authorities, no authority can be singled out for accountability. Here accountability acquires a different meaning: "Did the authority try its best to achieve goal or not?"

13. Alternative Law:

What is the alternative to FEMA?
This is an incorrect question.

In the past, the policy targets were tried to be achieved by a macro system covering several laws and several regulatory authorities.

Right question may be: What is the alternative to the past system? This means, we will need several laws and regulators working to achieve these goals.

14. Alternative System:

This has to be a macro level system of legal and economic measures to achieve the Goals by taking Indian genuine business in confidence. Following steps may be considered.

14.1 FEMA:

Scrap present FEMA. Rewrite the FEMA with Goals, Powers and Accountability. In the administration of FEMA ensure complete and real independence of RBI. Once Parliament sets revised goals, RBI will be the best institution to administer FEMA.

Within FEMA scrap sections 3 and 8 – prohibitions to pay and invest abroad. Set the exporters free. Scrap all declarations they have to file. Let there be no compulsion to bring back export proceeds.

Apart from other benefits, its Chief benefit will be **Enforcement Directorate** will be redundant. Dissolve it. India will achieve its goals by taking the business community along; and not be terrorising it.

14.2 Pay a **Real Rate of interest** to all savers in Indian Rupee.

14.3 Let MOF & RBI work together to stabilise and then appreciate Rupee by at least 2% a year. We will have a flood of capital coming into the country. FEMA – the portion enforcing forced capital retention in India – will be redundant.

These are massive steps. Will take a few years. But start with a Sankalpa – a determination to achieve the goals. Many things will fall in line.

14.4 Make a separate law to deal with Foreign Exchange Speculation.

14.5 FERA & FEMA are classic illustrations of bad drafting of law. RBI managers who drafted FEMA are excellent bankers & poor draftsmen. Similar trend is observed in Income-tax. The law is being drafted by tax commissioners. Hence it is totally one sided. One step away from being draconian law.

No law can be drafted by bureaucrats or juniors. Laws should be drafted by the Law Ministry. Then put up for scrutiny by the nation. Then considered by Parliament.

Conclusion:

Indian businessman deserves to be free from terror of law. Democratic laws & right policies free from lobbies can establish sound future for Indian economy. With the help of FSLRC, it will.

Thanking you,

Yours faithfully,
For Rashmin Sanghvi & Associates
Partner

Rashmin Sanghvi.