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Perspectives

India's Foreign Exchange Regulatory Transition: Western Pressure or an Indian Initiative?

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ABSTRACT

This article provides a critique of how the transition from FERA to FEMA was largely influenced by foreign pressure from first-tier countries and multilateral lending agencies. While key Indian policymakers had provided significant input into developing the overall structure, the success of FEMA's ability to attract foreign investment and strengthen India's foreign-exchange reserves has been greatly undermined by the vulnerabilities associated with dependence on U.S. dollars, fluctuations in capital markets due to high volatility in interest rates and the resulting regulatory arbitrage carried out through formal FDI caps; the costs borne by smaller businesses because of their inability to afford compliance with operational requirements; and the lag in regulatory measures related to digital financial services. What was initially used as means of trade among merchants has ultimately developed into means of exchanging currencies and financing various forms of trade and commerce by means of contracts based on money.

KEYOWORDS: FERA, FEMA, Multilateral Lending Agencies, Foreign Direct Investment, India

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INTRODUCTION

Transition from Foreign Exchange Regulatory Act, 1973 (FERA) to Foreign Exchange Management Act, 1999 (FEMA) marked a major fiscal reform in the wake of globalization, liberalization and privatization in India. The departure from "regulation" to "management" in the context of FEMA was considered India's voluntary acceptance of Globalization - an autonomous domestic policy decision to liberalize the foreign exchange environment of the country, bringing it into alignment with internationally accepted financial processes. This idea of liberalization is reflected in the language used in the preamble of the FEMA regarding "facilitating external trade", "promoting the orderly development of the foreign exchange market" and "maintaining balance of payments stability" - all indicative of an economy that is confident and looking outward.[1]

Analysis of the geopolitical, economic, and social context during this time leads to a more uncomfortable question: was there really any choice in how this process took place, or was it instead a deliberate strategy of Western government and international organizations[2] to create further access to one of the largest consumer markets in the world? After creating this access, did FERA establish stability and growth, or did it simply replace one type of vulnerability through the establishment of a very unstable capitalist system based on dollar-denominated global capital markets?[3]

THE HISTORICAL ARCHITECTURE OF FERA: CONTROL AS SOVEREIGNTY

The Foreign Exchange Regulation Act, enacted in 1973, emerged during a time of genuine scarcity in foreign currency. At the time, the Indian rupee was linked to the British pound, and India functioned under a system of administered rates of exchange coupled with very strict controls on capital movements. FERA was based on "rigidly enforced control mechanisms", and those

[1] R. K. Pattnaik, et al. "Exchange Rate Policy and Management: The Indian Experience." Economic and Political Weekly, vol. 38, no. 22, 2003, pp. 2139–53. JSTOR, http://www.jstor.org/stable/4413624.

[2] MARIO, G. (1992). "Chapter 3 The Role of the BIS in International Monetary Cooperation and Its Tasks Relating to the ECU". In *Current Legal Issues Affecting Central Banks, Volume I*. USA: International Monetary Fund. Retrieved Mar 25, 2026, from https://doi.org/10.5089/9781557751423.071.ch003

[3] Jacques Sapir, 'Are We on the Verge of a Major Transformation of the Global Economy?' (2020) 31 *Studies on Russian Economic Development* 606

violations were managed via an "approach that was highly criminal in nature", during a period when there was a shortage of foreign currency and thus used a "restrictive and quasi-criminal method".[4]

This system of criminality did not exist as purely a bureaucratic excess but was part of a more profound sovereign rationality. The need for the state to control access to and maintain monetary stability by curbing the outflow of capital, the use of the rupee in speculative activities, and maintaining the import capacity of India was a significant part of this factor. An interesting analog in the literature of comparative international systems is the description of the foreign exchange monopoly present in the nations of the Council for Mutual Economic Assistance (CMEA) bloc. They characterized the future "useful" allocation of state-controlled foreign exchange resources and provided an interesting description of the logic that drove the creation of the FERA structure in India.[5]

Monopolization and liberating of foreign exchange controls is a core policy conflict, as well as how centralizing allocation systems creates rent-speaking distortions, forces exporters to surrender convertible currency receipts, and causes chronic shortages and black markets. Similarly, India under FERA experienced the same issues. Which raises an important question directly pertaining to India: *does liberalizing allow for a proper cure to the systemic problem, or does liberalizing simply replace state-created rigidities with market-created volatility*[6, 7]

[4] Nithila P and MD Chinnu, 'A Study on Performance of Foreign Exchange Management Act 1999' (2026) 5(1) *International Journal of Research in Academic World* 11.

[5] Crockett, Andrew D. "Control over International Reserves (Surveillance Des Réserves Internationales) (El Control de Las Reservas Internacionales)." Staff Papers (International Monetary Fund), vol. 25, no. 1, 1978, pp. 1–24. JSTOR, https://doi.org/10.2307/3866653.

[6] Stock market volatility refers to the frequency and size of a market move in an upward or downward direction over a specified period. The larger and more frequent the price move, the higher the volatility. In statistical terms, volatility is the standard deviation of a market's annualised returns over a given period

[7] Nagy, A. "Monopoly and Liberalization of Foreign Exchange Control." Acta Oeconomica, vol. 41, no. 3/4, 1989, pp. 377–401. JSTOR, http://www.jstor.org/stable/40729411.

WAS FERA'S REPLACEMENT EXTERNALLY DRIVEN? THE CASE FOR WESTERN PRESSURES

The 1991 Crisis and IMF Conditionality

The external factors that made India's transition from FERA to FEMA have the strongest evidence found in the order of events that took place during India's 1991 balance of payments crisis.[8] Due to the crisis India had to pledge the gold that it held with the Bank of England and the Bank of Japan and was forced to access emergency IMF funds to support the provision of a complete structural adjustment program as a condition of receiving support during the crisis. It was within this framework of conditionality that the intellectual blueprint for FEMA was developed. One can trace a major change in the way India manages their foreign exchange reserves as a result of the Balance of Payment crisis, by moving to an indicator-based system from the simple metric of using the reserves to cover imports.[9] This major shift in reserve management philosophy was not driven internally by India, but rather has developed from the 1991 Balance of Payment Crisis and subsequent engagement with the IMF.[10]

The establishment of reserves in India after 1993 was partly intended to protect against negative external shocks and to provide a mechanism for compensating for the inability to resolve long-standing domestic economic challenges, both of which can be seen as central to the political economy of post-conditionality adjustment. Post structural reforms were imposed by the IMF, policymakers in India established reserves to protect themselves from future external vulnerabilities, thus creating a defensive posture based on a recognition of their external vulnerability.[11]

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[8] Arvind Virmani, *India's BOP Crisis and External Reforms: Myths and Paradoxes* (Indian Council for Research on International Economic Relations, December 2001) <https://www.icrier.org/pdf/AV-%20on%20BoP%20crisis.pdf>

[9] Y. V. Reddy. (2002). India's Foreign Exchange Reserves: Policy, Status and Issues. *Economic and Political Weekly*, *37*(20), 1906–1914. http://www.jstor.org/stable/4412131

[10] Y. V. Reddy. "India's Foreign Exchange Reserves: Policy, Status and Issues." Economic and Political Weekly, vol. 37, no. 20, 2002, pp. 1906–14. JSTOR, http://www.jstor.org/stable/4412131..

[11] Kapur, Devesh, and Urjit R. Patel. "Large Foreign Currency Reserves: Insurance for Domestic Weaknesses and External Uncertainties?" Economic and Political Weekly, vol. 38, no. 11, 2003, pp. 1047–53. JSTOR, http://www.jstor.org/stable/4413342..

The FEMA Provisions: Liberalization as Market Access

One of the most significant innovations implemented by FEMA was the provision that allowed for foreign investment via capital flows on capital accounts.[12] Specifically, Section 6 of the Foreign Exchange Management Act[13] allows for a limited form of capital account convertibility (that is, the ability to convert local currency to foreign currency and vice versa) to be granted by means of regulations formulated by the RBI. This provision was not solely a technical modification, but rather a significant structural change in that it opened up India's capital account for foreign institutional investors and investors wishing to access equity/debt in India - which have largely resulted in benefits to western financial entities desiring entrance into the Indian capital market.[14] The decriminalization of violations of Foreign Exchange Regulation Act (FERA) through Foreign Exchange Management Act (FEMA) had a similar positive effect on international investors who had been discouraged from participating in the Indian economy due to the harshness of FERA's enforcement mechanisms. A major outcome of the shift from criminal liability with FERA to civil liability with FEMA makes compliance less daunting for businesses. Although the change appears to be a reform within India, it is primarily meant to benefit the multinational corporations and foreign institutional investors who could now do business in India's forex markets without the risk of being criminally prosecuted for minor infractions of the foreign exchange regulations.[15] Albeit, interestingly, in 2015, a specific provision for criminality was reintroduced, perhaps signaling a slight shift from "management" to "regulation".[16]

The FDI Regulatory Framework: Opening Sensitive Sectors

FEMA was created especially to aid in foreign access to new sectors that were not open prior to the liberalization of FDI in India. India has now generalized FDI to essentially liberalize all sectors of the economy but has established upper limits on FDI (usually 26%, 49% or 74%) for many

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[12] Reserve Bank of India, Master Circular on Foreign Investment in India, RBI/2011-12/15 Master Circular No. 15/2011-12, July 1, 2011, https://www.rbi.org.in/CommonPerson/english/scripts/Notification.aspx?Id=856

[13] Foreign Exchange Management Act, 1999, 6

[14] Dhar, Biswajit, and Mritiunjoy Mohanty. "FEMA: A Closer Look." Economic and Political Weekly, vol. 33, no. 40, 1998, pp. 2569–70. JSTOR, http://www.jstor.org/stable/4407236.

[15] Nithila P and MD Chinnu, 'A Study on Performance of Foreign Exchange Management Act 1999' (2026) 5(1) *International Journal of Research in Academic World* 11.

[16] Foreign Exchange Management Act, 1999, 13, (1) C, added via 2015 amendment

sensitive sectors such as defense, insurance, civil aviation, print media, broadcasting, telecommunications, banking and single brand retail. The specifics of the limits have been established through various levels of lobbying from Western countries and corporations who are seeking access to these valuable markets.[17] According to economic theory, the three principal contributions of FDI to a host country are: "(1) the financial capital invested by foreign firms; (2) the export market access provided by them; and (3) the faster technology development that is expected to occur through technology transfer as part of the FDI package." (Francis, 2010)[18]

The Indian market has always been an asset to capital exporting western nations, "IMF loans are not provided entirely up front—to receive continued disbursements of the loans, governments are expected to comply with specific policy conditions, reviewed on a quarterly basis. These arrangements are notorious for stringent and controversial economic austerity. During the East Asian Financial Crisis, much-needed liquidity came at the price of national sovereignty as the IMF required tight monetary policy and fiscal contraction in return for continued disbursements of credit."[19] In an interesting parallel development, senior managers of U.S. corporations were cognizant of the shift in economic activity to emerging markets in the 1990s and how ethnocentrism in global management hampers their ability to compete globally. This corporate imperative led to governmental and multilateral demands for increased access to capital and management control in emerging markets such as India.[20]

The Globalization–Labor Rights Structural Parallel

Building on the connect between economic globalization and political globalization and the connection between these two types of globalization and workers' right to collective bargaining in

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[17] Dhar, Biswajit, and Mritiunjoy Mohanty. "FEMA: A Closer Look." Economic and Political Weekly, vol. 33, no. 40, 1998, pp. 2569–70. JSTOR, http://www.jstor.org/stable/4407236.

[18] FranciS, S. (2010). Foreign Direct Investment Concepts: Implications for Negotiations. *Economic and Political Weekly*, *45*(22), 31–36. http://www.jstor.org/stable/27807076

[19] Dreher, A., Sturm, J.-E., & Vreeland, J. R. (2015). Politics and IMF Conditionality. *The Journal of Conflict Resolution*, *59*(1), 120–148. http://www.jstor.org/stable/24546221

[20] Tung, Rosalie L., and Edwin L. Miller. "Managing in the Twenty-First Century: The Need for Global Orientation." MIR: Management International Review, vol. 30, no. 1, 1990, pp. 5–18. JSTOR, http://www.jstor.org/stable/40228002.

the developing world establishes a structural parallel to the situation of India; panel data collected from 142 developing countries between 1985–2002 and concludes that political globalization does not show a reliable relationship with increased labor and social protections, while economic globalization has produced mixed effects for the countries studied. With respect to FERA-FEMA's transition, India was integrating into a set of international institutions (WTO accession, BIT negotiations, IMF surveillance) during the 1990s that included implicit and explicit pressures to liberalize capital flows, decrease exchange controls and open markets, which were structural pressures rather than simply advisory, the most common types of structural conditions refer to "institutional reform, tax and revenue policy, expenditure policy, and public wages and employment" (Goldstein 2000, p41 – also see Mercer-Blackman and Unigovskaya 2000) [21]

THE COUNTER-NARRATIVE: DOMESTIC AGENCY AND INSTITUTIONAL DESIGN

To present the transition from FERA to FEMA as an event that was *"purely"* forced upon India from the outside would be an intellectual misrepresentation, there is in fact, a space for nuance. There are a number of indications that Indian policymakers had real freedom (and used it) when creating FEMA; it also reflects both internal development needs and external pressure. With respect to the regulatory mechanisms of FEMA, the Indian government has pursued a method of "community flexibility[22]", somewhere between a floating exchange rate and a pegged exchange rate; and the Reserve Bank of India (RBI) has intervened to smooth out excessive fluctuations, but not through established objectives or bands. This reflects a sophisticated process of domestic policymaking and does not demonstrate the imposition of IMF standards. The Indian regulatory innovation exemplified by the Rangarajan Committee's developing the use of multiple indicators to evaluate the adequacy of reserves is a unique institutional development in India, whereas the use of multiple reserve indicators by the IMF is an externally derived formula.[23]

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[21] Vadlamannati, Krishna Chaitanya. "Rewards of (Dis)integration: Economic, social, and political globalization and freedom of association and collective bargaining rights of workers in developing countries." ILR Review, vol. 68, no. 1, 2015, pp. 3–27. JSTOR, http://www.jstor.org/stable/24810278.

[22] Rolita Gupta, 'Standardizing Foreign Exchange Laws' (2024) *Chartered Secretary Journal* (Institute of Company Secretaries of India, New Delhi) <https://www.icsi.edu/media/webmodules/CSJ/November/15.pdf>

[23] Y. V. Reddy. "India's Foreign Exchange Reserves: Policy, Status and Issues." Economic and Political Weekly, vol. 37, no. 20, 2002, pp. 1906–14. JSTOR, http://www.jstor.org/stable/4412131.

FEMA's withdrawal from regulating foreign investment has made India's local rules for monitoring foreign direct investment weaker.[24] However, India still possesses many avenues for monitoring foreign direct investment through their central bank (RBI) and regulating investment portfolios through a securities commission (SEBI). There was risk to the multilateral investment regime due to the global financial crisis, which the Indian government understood at the time and sought to limit, due to the risks of liberalizing the economy.[25] The shift towards modernizing, globalizing and complying with international financial standards was treated as an intentional multi-facetted decision rather than simply yielding to external imperatives.[26] In fact the reality is much more complex; the Indian government was faced with both a real structural crisis and external pressures, but was also making decisions in relation to their developmental ideologies and institutional economic capacity of the time. [27]

HAS FEMA HELPED THE INDIAN ECONOMY OR CREATED DOLLAR VULNERABILITY?[28]

The Positive Case: Investment, Growth, and Reserve Accumulation

There is a significant amount of empirical evidence to support that "FEMA" has positively contributed to the Indian economy. 47.76% of respondents believe FEMA has made India more appealing for foreign investment, with an additional 17.91% who strongly agree, leading to an overall positive response rate of over sixty-five percent. The analysis rejected the null hypothesis (FEMA does not have a significant impact on Foreign Direct Investment (FDI) inflows or supporting economic growth), while accepting the alternative hypothesis (FEMA implementation

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[24] Deva, S. (2008). Foreign Venture Capital Investment: The Indian Experience. *The International Lawyer*, *42*(1), 177–192. http://www.jstor.org/stable/23824442

[25] Dhar, Biswajit, and Mritiunjoy Mohanty. "FEMA: A Closer Look." Economic and Political Weekly, vol. 33, no. 40, 1998, pp. 2569–70. JSTOR, http://www.jstor.org/stable/4407236.

[26] Johri, A. (2024). Examining the Impact of International Financial Reporting Standards Adoption on Financial Reporting Quality of Multinational Companies. International Journal of Financial Studies, 12(4), 96. https://doi.org/10.3390/ijfs12040096

[27] Nithila P and MD Chinnu, 'A Study on Performance of Foreign Exchange Management Act 1999' (2026) 5(1) *International Journal of Research in Academic World* 11.

[28] Viral V. Acharya, Soumya Bhadury, and Jay Surti, "Financial Vulnerability and Risks to Growth in Emerging Markets," NBER Working Paper 27411 (2020), https://doi.org/10.3386/w27411.

and its positive impact on FDI inflow and supporting economic growth).[29] There has been an increase in the foreign exchange reserves of India, which has increased from approximately $5.8 billion as of March 31, 1991 to approximately $54-55 billion by 2002 (approximately a 10-fold increase in reserves over the liberalization period of FEMA, 1998-2006). This increase in reserves has provided India with substantial macroeconomic buffers. According to Pattnaik et al., reserves have also increased between March 1996 and March 2003 (by approximately 3 times).[30]

Afterwards, its economic reforms were initiated in 1991 through the end of June 2001. The quarterly data on foreign direct investment (FDI) and foreign portfolio investment (FPI), along with several variables including Bombay Stock Exchange (BSE) equity market performance, infrastructure and twelve-month Treasury bill (TBILL) yields. All three of the above-mentioned factors consistently attracted both FDI and FPI. FEMA, therefore, laid out the legal foundation for the conversion of these capital market signals into real capital inflows, which is an objectively measurable contribution.[31] Furthermore, documents related to foreign VC investments are just as illustrative of the FEMA regulatory innovations. The regulatory innovations referred to include the new SEBI registration requirements, FIPB approvals, and regulations on the implementation of foreign investment through current accounts under FEMA. The result of these regulatory changes was that India developed a domestic VC ecosystem in IT and service sectors, which has been a tremendous contributor to job creation and export growth.[32]

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[29] Nithila P and MD Chinnu, ‘A Study on Performance of Foreign Exchange Management Act 1999’ (2026) 5(1) *International Journal of Research in Academic World* 11.

[30] Y. V. Reddy. “India’s Foreign Exchange Reserves: Policy, Status and Issues.” Economic and Political Weekly, vol. 37, no. 20, 2002, pp. 1906–14. JSTOR, http://www.jstor.org/stable/4412131.

[31] Krishna, M. Jaya, and J. Venugopal. “DETERMINANTS OF PRIVATE FOREIGN INVESTMENT IN POST-REFORM INDIA.” Savings and Development, vol. 27, no. 4, 2003, pp. 441–61. JSTOR, http://www.jstor.org/stable/25830843.

[32] Deva, Swati. “Foreign Venture Capital Investment: The Indian Experience.” The International Lawyer, vol. 42, no. 1, 2008, pp. 177–92. JSTOR, http://www.jstor.org/stable/23824442.

The Vulnerability Case: Dollar Dependence and Portfolio Volatility

However, this optimistic view is tempered by the structural weaknesses created through liberalisation of the FEMA imposed by the Reserve Bank (RBI).[33] India's official reserve level fails to reflect the true external vulnerability experienced within India and understate the actual level of India's external risk due to the failure to quantify the value of market-related obligations resulting from foreign institutional investor (FII) holdings, as well as from some forms of foreign direct investment (FDI).[34]

There is a significant drain of foreign exchange from India due to profit taking from foreign institutional investors. Based on this estimate of FII market capitalization at the end of 2006 and 2007 (from about $127.5 billion to about $255.4 billion), the market value of total liabilities created by FII (on a combined basis) may be roughly the same as, or may be greater than, India's official foreign exchange reserves. The conclusions drawn from this analysis reveal a significant contradictory situation resulting from the architecture of the Foreign Exchange Management Act (FEMA): the Act was intended to liberalize capital inflows in categories of investments (short-term capital flow and portfolio investment) that have been historically very responsive to changes in global risk sentiment and that also correlate closely with changes in the value of the U.S. dollar.[35] The addition of another dimension that real (supply and demand) shock explanations makes up most of the differences in both Real Exchange Rates (RER) and Nominal Exchange Rates (NER), while Nominal Money Supply shocks are only a very minor component. Thus, it has been concluded that the external shock component delivered via dollar-denominated capital flows is a major driver of India's exchange rate dynamics; and, that the second significant component is also due to the increased volume of such capital flows because of the liberalization of capital account transactions under FEMA.[36]

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[33] Y V Reddy, 'Glimpses of the Indian economy and its financial sector' (Speech at the Central Bank of the Russian Federation, Moscow, 2 July 2007) <https://www.bis.org/review/r070704b.pdf>

[34] Chandra, Nirmal Kumar. "India's Foreign Exchange Reserves: A Shield of Comfort or an Albatross?" Economic and Political Weekly, vol. 43, no. 14, 2008, pp. 39–51. JSTOR, http://www.jstor.org/stable/40277314.

[35] *id.*

[36] R. K. Pattnaik, et al. "Exchange Rate Policy and Management: The Indian Experience." Economic and Political Weekly, vol. 38, no. 22, 2003, pp. 2139–53. JSTOR, http://www.jstor.org/stable/4413624.

The Forward Rate Problem and Predictive Failure

FEMA assumes currency market information being efficient, which is badly incorrect. In addition to a forward-spot rate relationship[37] that has almost no information regarding future spot rates (likewise, not enough information to offer systematic overshooting on new information and/or long-run reversion to fundamentals), exchange rates do not continuously assimilate information and return to fundamentals; instead, they function in a random-walk fashion that provides very slow mean reversions. [38]

The implications for India are significant. If we think of the rupee/dollar as a random walk with large spikes due to sentiment, not fundamentals, then capital flow liberalization under FEMA has created risk for Indian businesses, borrowers and the RBI. Reserve accumulation won't be able to hedge this risk fully. Jacques' review about managing foreign exchange risk shows this operational impact: foreign exchange risk is defined as the increased volatility or variability of total consolidated earnings that multinational companies will experience due to unanticipated changes to exchange rates, as well as translation risk arising when converting foreign-currency denominated assets and liabilities back into the reporting currency of the parent company. Therefore, Indian firms that borrowed in dollars under FEMA's liberalized external commercial borrowing framework are exposed to actual translation risk, therefore they have a concrete financial vulnerability.[39]

The Capital Account Convertibility Trap

An examination of India's exposure to changes in their balance sheet by comparison of China's and India's approaches to converting the capital account indicates that both countries began from highly bureaucratic and tightly regulated systems of direct government control and progressed

[37] Alan C. MacKinlay, 'Appendix 5A: The Term Structure of Interest Rates, Spot Rates, and Yield to Maturity' (Finance Department, Wharton School, University of Pennsylvania) <https://finance.wharton.upenn.edu/~acmack/Chapter_05_app.pdf>

[38] Goodhart, Charles. "The Foreign Exchange Market: A Random Walk with a Dragging Anchor." Economica, vol. 55, no. 220, 1988, pp. 437–60. JSTOR, https://doi.org/10.2307/2553908..

[39] Jacque, Laurent L. "Management of Foreign Exchange Risk: A Review Article." Journal of International Business Studies, vol. 12, no. 1, 1981, pp. 81–101. JSTOR, http://www.jstor.org/stable/154420..

towards an open system of converting the capital account, but while China has not yet completed "переход к свободной конвертации валюты"[40], they have made much more rapid progress towards capital account openness in the last 10 years. India has moved more quickly than China towards the liberalization of the capital account (especially in terms of portfolio investment), but without the risk-absorbing capabilities of the system in place with respect to how China has converted their capital accounts into an open capital account. China has provided investors with mixed signals through their slow, ambiguous conversion process but provides investors with much greater protection against sudden capital outflows than does India, which has implemented their system (FEMA) using rules-based principles; therefore, the system in China is more robust than that of India's. [41]

Gains from the boom have been disproportionately distributed; reserves and flow dynamics are thus not only a function of capital flows, but also a function of broader issues of inequalities and the role of democratic accountability. The wide availability of capital to large companies, foreign institutional investors and HNWIs[42] may create imbalances in markets and put ordinary Indians at risk through increased inflation and depreciation from reversals in capital flows.[43]

Compliance Complexity as a Structural Barrier

FEMA's weaknesses extend beyond macroeconomics and include microeconomics as well; particularly with regard to its complicated compliance procedures, FEMA creates disadvantages for smaller businesses owned by Indians, 79.1% of the respondents (Nithila and Chinnu, 2025) indicated that the complexity of FEMA's compliance requirements, together with the existence of multiple regulatory agencies, has a negative impact on business efficiencies and confidence in

[40] Switch to free currency conversion

[41] Desai, Padma. "Capital Account Convertibility in China and India: A Cautionary Tale of Two Countries." Financial Crisis, Contagion, and Containment: From Asia to Argentina, Princeton University Press, 2003, pp. 256–62. JSTOR, https://doi.org/10.2307/j.ctt9qh03n.23.

[42] High-Net-Worth Individuals (HNWIs)

[43] Chandra, Nirmal Kumar. "India's Foreign Exchange Reserves: A Shield of Comfort or an Albatross?" Economic and Political Weekly, vol. 43, no. 14, 2008, pp. 39–51. JSTOR, http://www.jstor.org/stable/40277314.

investors. The null hypothesis that there is no substantial impact of FEMA's compliance procedures on efficiency was completely rejected.[44]

A major challenge, according to 32.84% of respondents, was overlapping regulatory jurisdiction, followed by a lack of clarity about new technologies (25.37%), complicated compliance procedures (22.39%), and long enforcement processes (19.40%). People in cities generally pointed to overlap between the three regulators, the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), and the Enforcement Directorate, as a tripartite regulator, causing confusion about jurisdiction and requiring compliance with multiple regulations. The overlap also creates asymmetries in distribution between multinationals and smaller businesses, who don't have the same ability to absorb compliance costs.[45]

The asymmetry between the two groups makes the smaller group more vulnerable than the larger. The Foreign Exchange Regulation Act (FEMA) has developed a regulatory framework that allows large businesses, including domestic conglomerates, multinational corporations, and foreign institutional investors (FII) funds, to capture the benefits of liberalization while requiring smaller domestic businesses to incur a disproportionate level of compliance costs. Consequently, the structure of the Indian economy is increasingly skewed towards the needs of international capital, which is precisely the outcome that critics of liberalization as driven by the West would have expected.

THE RBI AS SHOCK ABSORBER: MANAGED FLEXIBILITY AND ITS LIMITS

In order to fully evaluate FEMA's vulnerabilities, the barrier RBI has set up between them and the severe impacts of liberalization. RBI has performed sterilization operations (through a combination of spot/forward/swap transactions, and interest rate and reserve requirements) in the past to mitigate volatility and thus limit the overall impact of external shocks on domestic prices. (Pattnaik et al., 2003). Structural Vector Autoregression (SVAR) analysis shows that contractionary monetary shocks (or higher interest rates) will lower both output and inflation from

[44] Nithila P and MD Chinnu, 'A Study on Performance of Foreign Exchange Management Act 1999' (2026) 5(1) *International Journal of Research in Academic World* 11.

[45] *id.*

a worldwide perspective, while also increasing the nominal value of the currency in the short run. In addition, that appreciation of reserves aided in restoring orderly foreign exchange conditions during periods of stress on the foreign currency and/or foreign investments. [46]

An analysis on the control of international reserves, as seen through the lens of the post-Bretton Woods monetary system, serves as an excellent framework for analyzing the Reserve Bank of India's (RBI) approach towards international reserves. The creation of appropriate mechanisms to better control the growth of global liquidity could be considered as part of the unfinished agenda of international monetary reform; the availability of international liquidity is viewed as being important since it could assist in influencing the decisions made about balance of payments adjustment policies.[47] The RBI's strategy for its reserve accumulation is India's attempt to assert its authority over its own adjustment decisions, nothing more and nothing less; its goal is to prevent reserve depletion from leading to either a chaotic devaluation or an undesirable IMF program.

The inherent limitation of the approach: surveillance alone will not replace the necessity of having mechanisms that will affect the overall level or distribution of reserves, particularly in situations where global imbalances are substantial. (Crockett. 1978) Even though India's reserve accumulation is impressive, it does not provide complete insulation from global dollar liquidity crises, abrupt changes in foreign institutional investor's inflow, or a fundamental decline in India's current account position. While it is true that a strategic reserve buffer does exist, it is also finite and, the official reports of the size of the reserve buffer are misleading; they do not consider the market value of liability. [48]

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[46] R. K. Pattnaik, et al. "Exchange Rate Policy and Management: The Indian Experience." Economic and Political Weekly, vol. 38, no. 22, 2003, pp. 2139–53. JSTOR, http://www.jstor.org/stable/4413624.

[47] International Monetary Fund, 'Article A001' (1978) *Finance & Development* 15(1) <https://www.elibrary.imf.org/downloadpdf/journals/024/1978/001/article-A001-en.pdf>

[48] Crockett, Andrew D. "Control over International Reserves (Surveillance Des Réserves Internationales) (El Control de Las Reservas Internacionales)." Staff Papers (International Monetary Fund), vol. 25, no. 1, 1978, pp. 1–24. JSTOR, https://doi.org/10.2307/3866653.

FEMA, FDI CAPS, AND THE ILLUSION OF CONTROL

The sectoral Foreign Direct Investment (FDI) caps are one of the key regulatory tools used by FEMA.[49] The formal caps could be deceptive in their provision of protection from foreign corporate control, and in fact provide considerably less protection than they suggest (Rao and Dhar 2011). For example, even at the formal 26 per cent cap on a foreign investor's shareholding in an Indian company, such an investor can still exert considerable influence over an Indian company through the company's Articles of Association, shareholder agreement and nominee directors as well as have veto power over the strategic direction of the Indian company.[50]

The example of Bharat AXA Life shows how the entire sectoral protection system under FEMA can be bypassed through creative contract structures AXA holds 22.2 percent interest directly and 10 percent via an SPV, thereby giving AXA effective control of the company even though it is limited to holding no more than 26 percent under the cap. The government developed rules under CFP 2010, and Press Note 2/2010 to require that indirect foreign equity be calculated in order to prevent circumvention through Indian entities; thus, indicating that FEMA's caps were being regularly evaded. [51]

The difference between how well FEMA has protected an investor formally and how many starkly differ in actual circumstances (outcomes) provides a certain type of vulnerability. While Indian legislators thought they still had sovereignty over these sensitive sectors of the economy, sophisticated, foreign, investor-level, functional control over them had already been established through means that do not conflict with FEMA's core statutory provisions. In directly opposing this view, the terms of the Foreign Exchange Management Act have allowed for the liberalizing of the economy to a point where they also provide "under the surface" opportunities for investors to use corporate power, they will continue to use these mechanisms to maintain control over their

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[49] Rao, K. S. Chalapati, and Biswajit Dhar "Foreign Direct Investment Caps in India and Corporate Control Mechanisms." Economic and Political Weekly, vol. 46, no. 14, 2011, pp. 66–70. JSTOR, http://www.jstor.org/stable/41152054.

[50] *id.*

[51] *id.*

Indian assets, while the documented statistics represent a relatively stable level of foreign GET (capital) inflow relative to Indian FDI statistics.[52]

SYNTHESIS: A DUAL VERDICT

Evidence gathered in previous sections demonstrates that FEMA has been created and that there are significant issues regarding how that has occurred and what may result from it. Regarding whether the replacement of FERA was a consequence of external forces, it can be concluded that there has indeed been strong external influence; however, there are serious qualifications with that conclusion. Indian policymakers had virtually no ability to avoid the tremendous external pressures arising from the combination of the crisis in 1991, conditions placed by the IMF to receive assistance, the efforts of Western-based corporations to obtain access to Indian markets and the prevailing ideology of the Washington Consensus developed in the 1990s. Consequently, there is strong evidence that FEMA's several characteristics (decriminalization of violations, limited liberalization of the capital account, limited relaxation of foreign institutional investor (FII) thresholds, and progressive relaxation of sectoral foreign direct investment (FDI) limits) all occurred as a result of external pressures, even though they were implemented through Indian processes.

Regarding FEMA's impact on India, opinions are mixed but FEMA has created more serious and intrinsic vulnerabilities than people realize. FEMA has attracted significant levels of foreign investment, built significant foreign exchange reserves, and has made the regulatory environment for businesses more favorable than (FERA). However, there are a number of ways in which FEMA has created vulnerabilities, with regard to the capital account architecture that FEMA has developed, that are sensitive to both dollar fluctuation and global risk perceptions, as well as via foreign investors using sophisticated investment structures to obtain corporate control via circumvention of formal sectoral caps; with respect to the cost of compliance faced by small

[52] Joshi, V., & Little, I. M. D. (1987). Indian Macro-Economic Policies. *Economic and Political Weekly*, *22*(9), 371–378. http://www.jstor.org/stable/4376740

businesses in India, and via the lagging regulatory responses to the changes created by the evolution of digital finance.[53]

The paradox of FEMA is that it has resolved the problem of the earlier era of foreign exchange that was created by FERA (scarcity and rigidity) and created a different set of problems based on abundance, openness and complexity. The shift from an era of controlled poverty of foreign exchange to potentially precarious wealth (the adequacy of foreign exchange reserves is uncertain, capital flow volatility is stable, the regulatory system has not kept pace with technological advances that are occurring and the system developed).

CONCLUSION AND POLICY IMPLICATIONS

The transition from FERA to FEMA was largely influenced by foreign pressure from first-tier countries and multilateral lending agencies. While key Indian policymakers had significant input into developing the overall structure, the success of FEMA's ability to attract foreign investment and strengthen India's foreign-exchange reserves has been greatly undermined by the vulnerabilities associated with dependence on U.S. dollars, fluctuations in capital markets due to high volatility in interest rates and the resulting regulatory arbitrage carried out through formal FDI caps; the costs borne by smaller businesses because of their inability to afford compliance with operational requirements; and the lag in regulatory measures related to digital financial services.

Considering these facts, several policy recommendations can be made. First and foremost, the Government of India needs to make a concerted effort to implement the inter-agency coordination reforms (Nithila and Chinnu 2025). Specifically, streamlining the overlapping jurisdictional authority of the Reserve Bank of India (RBI), Stock Exchange Board of India (SEBI), and the Enforcement Directorate for monitoring and enforcement purposes will reduce financial compliance costs for smaller businesses while ensuring that large capital flows are adequately

[53] Goodhart, Charles. "The Foreign Exchange Market: A Random Walk with a Dragging Anchor." Economica, vol. 55, no. 220, 1988, pp. 437–60. JSTOR, https://doi.org/10.2307/2553908.

monitored.[54] A second way to improve India's official reserve adequacy assessment is by using the market value of liabilities analysis developed by Chandra. Under this approach, there will be an honest assessment of India's true external vulnerability. Thirdly, the Foreign Exchange Management Act (FEMA) sectoral foreign direct investment (FDI) capital platform must be redesigned to address the contractual circumvention strategy. (Rao and Dhar, 2011) The current model of sectoral FDI capital platform appears to provide accurate protection, when in reality it does not. Fourthly, India should create regulatory guidance on the treatment of digital currencies, and cross-border fintech transactions under the FEMA framework.

At its core, however, policy makers in India must avoid further pressure to liberate the capital account until they have ensured the institutional capacity exists to manage the volatility resulting from this action. Comparing China with India is not that China's approach was apt, but rather that sequencing and timing of capital account liberalisation are critically important. In other words, India opened its portfolio investment account too early for its institutional capacity, and this vulnerability is evident every time there is pressure on the rupee associated with a global risk-off event.[55]

The Foreign Exchange Regulation Act (FEMA) needs to be understood in relation to the global changes taking place in the world's financial system starting from the 1970s. The creation of SWIFT in 1973, the development of the petrodollar system, and the increasing importance of such institutions as the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) have resulted in a fundamental change towards the increasing privatization, contract-based movement of money and the selection of market-based exchange rates. What was initially used as means of trade among merchants has ultimately developed into means of exchanging currencies and financing various forms of trade and commerce by means of contracts based on money. FEMA is both a remarkable success story of Indian Foreign Currency and India's largest and least resolved

[54] Nithila P and MD Chinnu, 'A Study on Performance of Foreign Exchange Management Act 1999' (2026) 5(1) *International Journal of Research in Academic World* 11.

[55] Desai, Padma. "Capital Account Convertibility in China and India: A Cautionary Tale of Two Countries." Financial Crisis, Contagion, and Containment: From Asia to Argentina, Princeton University Press, 2003, pp. 256–62. JSTOR, https://doi.org/10.2307/j.ctt9qh03n.23.

financial risk. The act removed the rigidity inherent in FERA and positioned India within the global capital markets but was done so under the terms largely developed by entities outside of India. This has resulted in a level of dependency on the dollar that limits India's monetary sovereignty in a way that is only partially offset by the reserve buffers the RBI has developed over time. Thus, striking a balance between maintaining an open market and rebuilding national sovereignty will be the most significant Foreign Exchange Policy challenge that India faces in the next 10 years.