Towards Fuller Capital Convertibility

Why in news?

The process of capital account convertibility is likely to receive a further push this year, as the government and RBI move towards allowing greater foreign participation in domestic bond markets.

What is the capital account convertibility?

- The balance of payments account, which a statement of all transactions made between a country and the outside world, consists of two accounts
    1. Current account
    2. Capital account
- While the current account deals mainly with import and export of goods and services, the capital account is made up of cross-border movement of capital by way of investments and loans.
- **Capital account convertibility**- It means the freedom to conduct investment transactions without any constraints i.e. no restrictions on the amount of rupees an Indian resident can convert into foreign currency to enable to acquire any foreign asset.
- Similarly, there should be no restraints on the NRI relative bringing in any amount of foreign currency to acquire an asset in India.

How did the capital account convertibility evolve?

- Economic liberalisation set in motion by the **Narasimham Committee's recommendations** in 1991 put India on the path to open the economy.
- Within five years, the country had moved to a market-determined exchange rate and full current account convertibility.
- The enactment of the Foreign Exchange Management Act, 1999 further liberalised current account, and to some extent, capital account transactions.
- The foreign direct investment (FDI) in India is largely unrestricted and in the past five years, the flow of FDI has accounted for almost 50% of total

FDI inflows since 1991.
- During 2021, FPIs invested 10.8 billion dollars in initial public offerings (IPOs) of Indian firms—the highest ever amount.
- In the three decades since liberalisation began, progress on this aspect has remained gradual and the current position is a **partially open capital account.**

Why is it important?

- Inflows and outflows of the foreign and domestic capital, which are prone to volatility, can lead to excessive appreciation/depreciation of their currency and impact the monetary and financial stability.
- India's prudence in opening up its capital account was lauded after the currency crisis in East Asian countries in 1997.
- The **SS Tarapore committee's report** on fuller capital account convertibility released in 2006 argued that even countries that had comfortable fiscal positions have experienced currency crises and rapid deterioration of the exchange rate.
- The report further points that an excessive appreciation of the exchange rate causes exporting industries to become unviable, and imports to become much more competitive, causing the current account deficit to worsen.
- **Efforts taken**
  - Increasing the foreign portfolio investment limits in the Indian debt markets
  - Introducing the Fully Accessible Route (FAR) — through which NRIs can invest in specified government securities without any restrictions
  - Easing of the external commercial borrowing framework by relaxing end-user restrictions
  - Allowing Inward FDI in most sectors
  - Allowing outbound FDI by Indian incorporated entities as a multiple of their net worth

How will the fuller convertibility benefit India?

- **Reduction in sterilization costs**-Large foreign exchange reserves lead to high sterilisation costs.
- Bringing some control over India's sterilisation costs through an opening of the capital account could free up almost 1% of GDP in sterilisation costs over time.

Sterilization is a form of monetary action in which a central bank seeks to limit the effect of inflows and outflows of capital on the money supply.

- **Economic development**- Further liberalisation of the capital account is needed to power the next stage of India's economic development.
- Limiting sovereign debt to 60% of GDP (as recommended by the **NK Singh panel**) should be part of economic policy in a post COVID-19 world.

References

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