Internationalization of Rupee

This editorial is based on **Internationalizing the rupee without the ‘coin tossing** which was published in The Hindu on 07/07/2023. It talks about benefits and challenges of internationalization of rupee.

For Prelims: Nominal GDP**,** Purchasing Power Parity**,** Fiscal Deficits**,** Rupee Vostro Accounts**,** Demonetisation**,** Reserve Bank of India**,** Monetary Policy**,** Inflation**,** Non-Performing Assets **,**Currency Swap Agreements

For Mains: **External Commercial Borrowings**, Benefits and Challenges of Internationalization of Rupee.

The rupee is the official currency of India, **the world’s fifth-largest economy** by **nominal GDP** and the **third largest by** purchasing power parity. The rupee is also used as a **legal tender in some of India’s neighbouring countries,** such as Bhutan and Nepal. However, the rupee is far from being a global currency, with a **very low share** in the international **foreign exchange market** and trade transactions.

Internationalisation of the rupee **refers to the process of increasing the use and acceptance** of the rupee outside India, for **trade, investment, reserve** and other purposes. Internationalising the rupee can have several benefits for India, however, it also entails several challenges and risks.

What is the Current Status for the Rupee's Internationalization?

- **Limited Progress in Internationalisation:**
  - The rupee is far from being internationalized, the daily average share for the rupee in the global foreign exchange market hovers around 1.6%, while India’s share of global goods trade is mere 2%.
- **Steps Taken to Promote Internationalisation:**
  - India has taken some steps to promote the internationalisation of the rupee (e.g., enable **external commercial borrowings** in rupees), with a push to Indian banks to open **Rupee Vostro accounts** for banks **from Russia, the UAE, Sri Lanka and Mauritius** and measures to trade with about 18 countries in rupees instituted.
  - However, such transactions have been limited, with **India still buying oil from Russia in dollars.**
- **Constraints on Currency Exchange:**
  - India does **not permit full** capital account convertibility (i.e., **allowing free movement of local financial investment** assets into foreign assets and vice-versa), with significant constraints on the exchange of its currency with others, driven by past fears of capital flight (i.e., outflow of capital from India due to monetary policies/lack of growth) and exchange rate volatility, given significant current and capital account deficits.
- **Concerns of Neighbouring Countries:**

- The rupee's internationalization **cannot make a start without accounting for the concerns** expressed by India's neighbours.
- The **demonetisation** of 2016 also shook confidence in the Indian rupee, especially in Bhutan and Nepal.
- Both countries continue to fear additional policy changes by the RBI (including further demonetisation).
- The move, in 2023, to **withdraw the ₹2,000 note** has **also impacted confidence** in the rupee.

What are the Benefits of Internationalising the Rupee?

- **Reduced Dependency on Foreign Currencies:**
  - Internationalisation of the rupee would reduce India's reliance on foreign currencies, **such as the US dollar,** for international trade and financial transactions.
  - This would **enhance India's economic sovereignty** and **reduce exposure** to currency fluctuations.
- **Increased Global Trade:**
  - Internationalisation of the rupee **can facilitate smoother international trade** by allowing parties to transact directly in rupees.
  - It would **eliminate the need for currency conversions**, reducing **transaction costs** and simplifying cross-border trade.
- **Enhanced Financial Integration:**
  - A globally recognised and widely used rupee can lead to increased financial integration.
  - It would **attract foreign investors** and **promote capital inflows,** leading to **greater investment opportunities** and liquidity in the Indian financial markets.
- **Improved Monetary Policy Effectiveness:**
  - Internationalisation can enhance the effectiveness of India's monetary policy.
  - With a broader international reach, the **Reserve Bank of India (RBI)** can use the exchange rate as a tool to manage inflation and stimulate economic growth.
  - It **provides greater flexibility** in managing monetary conditions and responding to economic challenges.
- **Strengthened Regional Influence:**
  - A globally accepted rupee can strengthen India's regional influence and position it as a major economic player in Asia.
  - It would promote trade and investment within the region, bolstering economic partnerships and collaborations.
- **Diversification of Reserves:**
  - Internationalisation of the rupee would **increase its attractiveness** as a reserve currency.
  - Central banks and foreign governments may choose to hold rupees as part of their foreign exchange reserves, providing diversification and stability to their portfolios.
- **Development of Financial Services:**
  - As the rupee gains international acceptance, financial services tied to rupee-denominated transactions, **such as trade financing, currency hedging, and settlement services**, would see growth.
  - This can foster the development of a robust and competitive financial services sector in India.

What are the Challenges of Internationalizing the Rupee?

- **Exchange Rate Volatility:**
  - Internationalising the rupee **exposes it to greater exchange rate volatility.** Fluctuations in the value of the rupee **can impact trade competitiveness, foreign investment flows,** and financial market stability.
  - Managing exchange rate risks becomes crucial in order to mitigate potential adverse effects.
- **Capital Flight and Financial Stability:**
  - Opening up the rupee to international markets may lead to capital flight if investors lose confidence in the currency or anticipate unfavourable economic conditions.

    - This **can strain the country's foreign exchange reserves,** impact financial stability, and create challenges for **monetary policy** management.
- **Capital Controls:**
    - India still has capital controls in place that limit the ability of foreigners to invest and trade in Indian markets.
    - These **restrictions make it difficult for the rupee** to be used widely as an international currency.
- **Competing Currencies:**
    - The rupee faces competition from established **international currencies like the US dollar, euro, and yen,** which enjoy widespread acceptance and liquidity.
    - Gaining market share and displacing these dominant currencies can be a significant challenge.
- **Confidence and Perception:**
    - The credibility and stability of India's economic and monetary policies play a crucial role in building confidence in the rupee.
    - Any perception of **policy uncertainty, lack of transparency, or geopolitical risks can impede** the internationalisation process.
- **Adoption by Market Participants:**
    - Convincing market participants, including **businesses, individuals, and financial institutions,** to adopt the rupee for international transactions requires trust, familiarity, and confidence in the currency.
    - Building **awareness and promoting the benefits** of using the rupee globally is a significant challenge.

How can India learn from China’s Experience in Internationalising the Renminbi?

- **China’s Phased and Calibrated Approach:**
    - Before 2004, the renminbi was limited to use within China.
        - By 2009, China expanded its use for trade, investment, and currency swaps with other countries.
        - In 2013, the Shanghai Free Trade Zone enabled unrestricted trading between non-resident onshore and offshore accounts.
- **China’s Achievements in Currency Internationalisation:**
    - Over time, China **achieved a significant degree of internationalization** of its currency, with reserve currency status increasingly enabled (e.g., by 2022, its share of international reserves had **reached ~2.88%**), as per an online article.
- **India’s Potential Strategies to Emulate China:**
    - India can match some of China’s strategies in pursuing a gradual and calibrated approach to internationalizing its currency, while ensuring that its domestic economic and financial conditions are conducive and resilient.
    - India can also leverage its existing trade and investment ties with countries in the region and beyond and seek to expand its currency swap arrangements and offshore bond market.

What are the Specific Reforms that India can Pursue to Internationalize the Rupee?

- **Make the Rupee More Freely Convertible:**
    - With a goal of **full convertibility by 2060**, letting **financial investments** move freely between India and abroad.
    - This would **allow foreign investors to easily buy and sell the rupee,** enhancing its liquidity and making it more attractive.
- **Pursue a Deeper Bond Market:**
    - Enabling foreign investors and Indian trade partners **to have more investment options in rupees**, enabling its international use.
- **Encourage Exporters/Importers for Transactions in Rupee:**
    - Optimising the **trade settlement formalities** for rupee import/export transactions would

go a long way.

- **Sign Additional** Currency Swap Agreements:
  - As with Sri Lanka, to allow India to settle trade and investment transactions in rupees, without resorting to a reserve currency such as the dollar.
- **Offer Tax Incentives:**
  - Offer Tax Incentives **to Foreign Businesses** to Utilise the Rupee in Operations in India.
- **Ensure Currency Management Stability and Improve the Exchange Rate Regime:**
  - Avoid sudden or drastic changes **such as devaluation or demonetisation** that can **impact confidence.**
  - Ensure consistent and predictable issuance/retrieval of notes and coins.
- **Pursue the Recommendations of the Tarapore Committees':**
  - Such as **reducing** fiscal deficits **lower than 3.5%,** reducing **gross** inflation **rate** to 3%-5%, and **reducing gross banking** non-performing assets **to less than 5%.**

Drishti Mains Question:

How does internationalisation of the rupee affect India's economic and strategic interests in the region and beyond?

UPSC Civil Services Examination Previous Year's Question (PYQs)

Prelims:

Q1. Convertibility of rupee implies (2015)

(a) being able to convert rupee notes into gold

(b) allowing the value of rupee to be fixed by market forces

(c) freely permitting the conversion of rupee to other currencies and vice versa

(d) developing an international market for currencies in India

Ans: (c)

Exp:

- Convertibility of rupee means freely permitting the conversion of rupee to other currencies and vice versa.
- Indian currency is fully convertible in the Current Account and partially convertible in the Capital Account.
- Current Account convertibility means freedom to convert domestic currency into foreign currency and vice-versa, for trade in goods and services. On the other hand, Capital Account convertibility means freedom of currency conversion related to capital inflows and outflows.
- Therefore, option (c) is the correct answer.