



## 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.