INTERNATIONALISATION OF RUPEE: INDIAN CURRENCY'S GLOBAL ASCENT

In the last three decades, India's external engagement has undergone a remarkable transformation, ignited by economic reforms. This journey has deepened connections with the world in terms of trade and investments. Simultaneously, the global financial landscape has been evolving, moving away from a dominant USD. These changes, coupled with recent geopolitical shifts, lay the groundwork for the ascent of alternative currencies, especially the Indian Rupee (INR), onto the international stage.

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1. What is internationalisation of a currency?

In the context of a rapidly evolving global economy, the concept of an international currency has become increasingly significant.

- An international currency can be referred to as the currency which is **used and held beyond the borders of the issuing country** for economic transactions.
- In other words, the internationalization of a currency is an **expression of the currency's external credibility,** as the economy of that country integrates globally.
- Just like a domestic currency, an **international currency performs the three functions** of money – **as a medium of exchange, a unit of account, and a store of value.**

Table 1.1 The Roles of an International Currency

Function	Sector	
	Private	**Official**
Unit of Account	Currency is used to invoice foreign trade and denominate international financial instruments.	Currency is used in expressing exchange rate relationships.
Medium of Exchange	Currency is used to settle international trade and to discharge international financial obligations.	Intervention currency in the foreign exchange markets and currency used for the balance of payments financing.
Store of value	Currency is used to denominate deposits, loans and bonds.	Reserve assets held by monetary authorities.

- The **US dollar, the Euro, the Japanese Yen and the Pound Sterling** are the leading reserve currencies in the world.
- **According to an IMF discussion note, the Indian Rupee,** the Brazilian Real, the Chinese Renminbi, the Russian Ruble and the South African Rand were **identified as the key emerging market currencies with the potential for internationalisation.**

The internationalisation of a currency is a continuous process and is closely interlinked with the nation's economic progress. Therefore, understanding the role and implications of international currencies is essential for understanding the intricacies of an interconnected global economy.

1.1.What are the prerequisites for the internationalisation of a currency?

Internationalisation gathers pace as a country progresses on the path of fulfilling the following pre-conditions:

- **Wide use in global transactions:** A currency with a large share in global Gross Domestic Product (GDP), trade and finance attracts more users and establishes network externalities.
- **Currency convertibility and a credible commitment to an open capital account:** This is needed to facilitate financial flows with minimal transaction costs and depth and thus developing a range of financial products.
- **Country should have stable financial and foreign exchange markets:** This facilitates the conduct of foreign exchange policies, manage currency risks effectively and support financial asset transactions denominated in the country's currency.
- **Other preconditions:**
  - **Removal of all restrictions** on any entity, domestic or foreign**, to buy or sell the country's currency.**
  - **Foreign firms, financial institutions, official institutions and individuals can hold the country's currency** and financial instruments/ assets denominated in it.
  - **International financial institutions,** such as the World Bank and regional development banks, **can issue debt instruments in a country's market** and use its currency in their financial operations.

Internationalisation of a currency needs to be a smooth process. It should be a continuous process of change in the financial architecture of economy thereby stimulating the international usage and demand for currency.

Box 1.1. What is the global experience vis-à-vis internationalisation of currencies?

- **US dollar has been the dominant global currency** for the better part of the last century due to a range of factors, including-
  - Size of the US economy,
  - Reach of its trade and financial networks,
  - Depth and liquidity of US financial markets, and
  - A history of macroeconomic stability and currency convertibility.
- **Dollar dominance has also benefited from the lack of viable alternatives;** the incomplete nature of the European monetary union (Euro); a shrinking population and uncertain debt dynamics in Japan (Yen); and the relative decline of the UK economy (Pound).
- In recent times, the **Chinese Renminbi has been emerging as a challenger** to the dollar, but its growth is contingent upon-
  - Future policies in both the US and China and
  - Ability of the Chinese economy and its financial system to demonstrate long-term resilience, integrity, transparency, openness and stability.
- **Other attractive stores of value** include the Swiss franc, the Canadian dollar, and the Australian dollar. Though these currencies are valuable, they **lack the scale to become a dominant global currency.**

2. Why is India focusing on the internationalisation of the INR?

Indian economy has experienced a profound transformation in recent years, marked by increased connectivity with the global landscape. The following developments are further fuelling its growth towards the internationalisation of the rupee-

- Increased **linkages of the Indian economy with the rest of the world** in terms of trade and capital flows.
- India is **among the world's fastest-growing economies** and is also a **preferred destination for global investors.**
- **Remarkable resilience shown by the Indian Economy** against adverse global developments, especially during the COVID-19 pandemic.
- **Decreasing share of USD** in foreign exchange reserves of countries and **increasing usage of other currencies** in trade invoicing and settlement.
- **Emergence of** various bilateral and regional **economic cooperation agreements.**

These developments not only reflect India's growing importance but also demonstrate the broader trend of a multipolar global economy. How India navigates this evolving global terrain will shape its economic future and influence the world's financial order.

2.1. What are the benefits and challenges of internationalisation of Indian Rupee?

Benefits of currency internationalisation accrue largely to a country's private sector and are fairly evident.

- **Limit exchange rate risk:** It broadens and deepens its financial market and domestic firms can invoice and settle their exports/imports in their currency thus shifting exchange rate risk to their foreign counterparts.
- **Increased access to financial markets:** Permits domestic firms and financial institutions to access international financial markets without assuming exchange rate risk and also offers new profit opportunities to financial institutions.
- **Boost capital formation in the economy:** Growth of a larger, more efficient financial sector encourages capital formation and simultaneously reduces the cost of capital for its participants.
- **Allow a country's government to finance part of its budget deficit:** This is done by issuing domestic currency debt in international markets rather than issuing foreign currency instruments.
- **Regulating Capital Flows:** At the macroeconomic level, it results in **lowering the impact of sudden stops and reversals of capital flows** and enhances the ability to repay external sovereign debt.

There is a possibility that internationalization may result in several Challenges. Some of these challenges include-

- **Exchange rate volatility:** It may result in a potential increase in volatility of its exchange rate in the initial stages.
- **Monetary Policy dilemma or Triffin dilemma:** It is a conflict that arises when a country needs to supply enough of its currency to meet global demand while also maintaining its domestic monetary policies.
  - **Balancing these two objectives** can be challenging because actions taken to meet global demand may have unintended consequences for the country's domestic economy, such as inflation or unstable financial conditions.
- **May accentuate an external shock:** Given the open channel of the flow of funds in and out of the country, it may increase the volatility of the financial system.
- **Macroeconomic and political stability:** Integration of financial markets could affect stability in the long-term.
  - Policymaking institutions with credibility and a track record of maintaining price stability are **critical ingredients** to sustaining **confidence in the currency's long-term purchasing power.**

2.2. What are the initiatives taken by India towards the Internationalisation of INR?

Various steps have been taken to increase the global use of INR with varied amounts of success.

- **Use of Indian Payment Infrastructure:** India initiated interlinkage of UPI with Singapore's PayNow; Money Transfer Service Scheme (MTSS), which is an inward payment service; National Payments Corporation of India (NPCI) reaching out to jurisdictions etc.
- **South Asian Association for Regional Cooperation (SAARC) swap framework:** RBI also provides liquidity to SAARC countries. The requesting central bank can make withdrawals in USD, Euro and also in INR.
- **Developments in Gujarat International Finance Tec-City (GIFT City)** such as hosting of Financial Market Infrastructures (FMIs), a depository (CDSL IFSC Limited) as well as a banking infrastructure with most of the leading banks in India participating.
- **Indo-Nepal Remittance Facility Scheme:** launched by the RBI in 2008 as an option for cross-border remittances from India to Nepal by leveraging the NEFT ecosystem available in the country.
- **Bilateral Swap Arrangements (BSA):** India currently has a BSA with Japan for an amount up to USD 75 billion as a backstop line of support in case of any balance of payments issue.
- **Arrangement for Bilateral Trade Payments between India and Iran:** Under the arrangement, the Indian Rupee vostro accounts of Iranian banks are credited 100 per cent in INR by Indian importers, against invoices from entities in Iran.
- **INR becoming a Designated Foreign Currency in Sri Lanka** facilitating international trade and cross-border banking transactions.
  - **Authorising INR as a designated foreign currency would bring many advantages** to Sri Lanka including-
    - **Facilitation of smooth banking transactions** relating to INR especially for small-scale traders,
    - **Encouraging traders to use banking channels** for trade transactions over informal channels,
    - **Reducing additional transaction costs** associated with the dual conversion of INR into USD and thereafter into LKR and vice-versa.
- **Asian Clearing Union (ACU):** RBI had proposed the use of local currencies of members for settlement of ACU transactions thus mooting the idea of INR also being included as one of the settlement currencies under the ACU.
- **Others:** Allowing issuance of offshore Rupee-denominated 'masala' bonds, allowing domestic banks to freely offer foreign exchange prices to non-residents at all times etc.

Further, internationalisation of the INR would involve a series of coordinated public policy steps. Thus, a template or standardised approach must be prepared to accelerate the pace of internationalisation of INR.

3. What should be India's approach towards the internationalisation of INR?

Internationalisation of INR is a process rather than an event, and thus to enable, track and monitor the progress, certain milestones for implementation are needed.

3.1. Promoting international use of INR

- **Currency Swaps and Local Currency Settlement (LCS):** It provides currency diversification that stabilises the local currency and provides a natural hedge for the business community to protect against currency risk exposure.
- **Sufficient INR Liquidity:** It would facilitate payment and settlement of offshore INR transactions and is therefore crucial for INR to be accepted internationally as a settlement currency.
- **Clearing of transactions in Government securities through International Central Securities Depositories (ICSDs):** To increase the participation of non-residents in the G-sec market and lower borrowing costs for the Government by expanding the investor base in the G-sec market.
- **INR-denominated payment mechanism for cross-border transactions:** It will help to reduce transaction cost, and also to reduce our dependence on international payment systems based on the SWIFT messaging system.
    - India's advanced payment systems like Real Time Gross Settlement (RTGS), National Electronic Funds Transfer (NEFT) and Unified Payments Interface (UPI) can be leveraged for this.
- **Becoming a part of Continuous Linked Settlement (CLS):** Considering the growth in the Indian economy and the increase in trade, it is felt necessary that INR is also included as a direct settlement currency in CLS.
    - CLS is a global system for the settlement of foreign currency transactions.
- **Creation of an Indian Clearing System:** It will bring greater efficiency in the settlement in domestic currencies, by carving a marketplace for these currencies that are not freely convertible.
- **INR as a vehicle currency/contender to Special Drawing Rights (SDR) basket:** It can be taken forward by encouraging trade invoicing in INR by expanding trade relations with other economies, where Indian firms may have some competitive edge and can act as price-makers.

Box 3.1 Special Drawing Rights (SDR)

- SDR is an **international reserve asset**, created by the IMF in 1969 to **supplement its member countries' official reserves.**
- Its **value is based on a basket of five currencies:** US dollar (highest weightage), Euro, Chinese Yuan, Japanese yen, and British Pound Sterling (lowest weightage).
- It is **allocated to IMF member countries in proportion to their relative share** in the IMF.

3.2. Strengthening the Financial Markets

- **Harmonisation of KYC norms of RBI and SEBI** to take care of category of FPIs, KYC documentation and certification of Officially Valid Documents.
- **Promoting India as the hub of INR transactions** and the main centre for INR price discovery (process which determines market prices, mostly through interactions between buyers and sellers).
- **Global 24x5 INR market:** While customer transactions are facilitated round-the-clock in the offshore market, the inter- bank market operates through Indian branches only and operates only for a limited set of hours onshore.
- **Inclusion of Indian Government Bonds in Global Bond Indices.**
    - Global bond **indices include bonds of various emerging markets** and participation in these helps in launching the country and its stocks on a large arena, which would boost investor participation, confidence and liquidity for the stock and/ or the country.

3.3. Liberalising the capital account

Internationalisation of the INR and capital account convertibility are processes which are both closely and symbiotically intertwined with each other.

- **Need to review extant regulations and guidelines:** Revisiting Know Your Customer (KYC)/Anti Money Laundering (AML) requirements and steps to remove frictions in the current Financial Action Task Force (FATF) and Prevention of Money Laundering Act (PMLA) provisions to facilitate the flow of INR-based trade transactions.
- **INR accounts outside India:** Consider settling all permissible capital and current account transactions

not only through onshore INR accounts but also through offshore INR accounts.

- **Banking Services** (loans, guarantees, credit lines, etc.) **in INR** through offshore branches of Indian banks.

What is Capital Account Convertibility?

- **Balance of payments (BOP)** of a country **records all economic transactions of a country** (that is, of its individuals, businesses and governments) **with the rest of the world** during a defined period, usually one year.
- These transactions are **broadly divided into two heads – current account and capital account.**
  - **Current account covers** exports and imports of goods and services, factor income and unilateral transfers.
  - **Capital account records** the net change in foreign assets and liabilities held by a country.
- **Convertibility refers to the ability to convert domestic currency into foreign currencies and vice versa** to make payments for BoP transactions.
  - **Capital account convertibility** is the ability or freedom to convert domestic currency for capital account transactions.
    - The **Tarapore Committee (2006) defined capital account convertibility** as the "freedom to convert local financial assets into foreign financial assets and vice versa."
  - **Current account convertibility** is the ability or freedom to convert domestic currency for current account transactions.

Why is capital account convertibility important?

- Free capital mobility, or internationalization of capital markets, is commonly **recognized as an engine of global growth.**
- **Specifically, the benefits of internationalization** of capital markets are well accepted, in terms of **broadening the investor base for recipient country's financial assets, improved liquidity in financial markets** and positive pressures for market infrastructure and market practices.

What are the risks of free capital mobility?

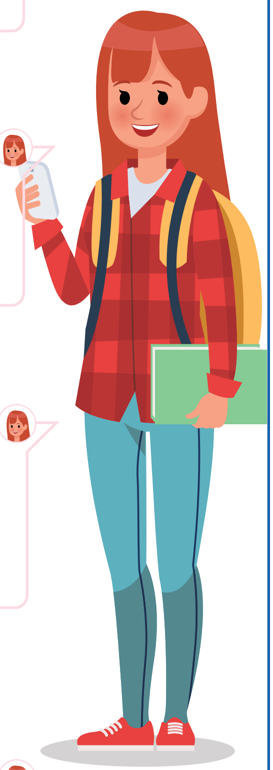
- **Exposure to global shocks, credit and asset bubbles, exchange rate volatility** associated with sudden exit of capital and higher refinancing risk.

How can these risks be managed?

- A **well-developed financial system and a sound market infrastructure,** including efficient markets for funding and risk transfer.
- **Capital flow regulations based on risk assessment:** foreign direct investment is the least risky, followed by equity investment, followed by debt capital.

Box 3.2 In Conversation: The impossible trinity: How the free movement of capital comes with a cost

Vinay



Vini

Vini: Hey Vinay, have you ever heard of the "impossible trinity"?

Vinay: Impossible trinity? What's that?

Vini: It's this economic concept that says you can't have all three of these things at once: a fixed exchange rate, free movement of capital, and an independent monetary policy.

Vinay: Whoa, that sounds complicated. Break it down for me.

Vini: Alright, so think of it like this. Imagine your parents give you an allowance, and you want to save it, invest it, and spend it freely. But you can't do all three. If you save it, you can't spend it freely, and if you spend it freely, you can't save it. Get it?

Vinay: Oh, I see! So, like, if a country wants to have a fixed exchange rate and free movement of capital, they can't control their own interest rates?

Vini: Exactly! They have to give up a part of control over their monetary policy. It's like a trade-off.

Vinay: That's interesting. So, it's like a balance between economic stability and freedom.

Vini: Yep, and that balance can be pretty tricky to achieve. It's like trying to juggle three balls at once!

Vinay: I get it now! Thanks for explaining, Vini.

Vini: No problem, Vinay.

4. Conclusion

India's external sector has shown remarkable progress in the last three decades after the economic liberalisation reforms were set in motion. The significant surge in foreign exchange reserves, FDI, imports, and exports over the last decade reflects this transformation. As India continues to build on its economic strengths and navigate these changes, the prospect of the INR gaining greater international recognition and utility becomes increasingly plausible.

TOPIC AT A GLANCE

Internationalisation of Rupee

- An international currency is **used and held beyond the borders of the issuing country** for transactions between residents and non-residents, and between residents of two countries other than the issuing country.
- It **performs the three functions** of money – **as a medium of exchange, a unit of account, and a store of value.**
- **US dollar, the Euro, the Japanese yen and the pound sterling** are the leading reserve currencies in the world.

Benefits of internationalisation of currency

- **Limit exchange rate risk.**
- **It permits access to international financial markets** without assuming exchange rate risk.
- **Boost capital formation** in the economy.
- **Allow a country's government to finance part of its budget deficit** by issuing domestic currency debt in international markets rather than issuing foreign currency instruments.
- **Reduces the requirement to maintain and depend on large foreign exchange reserves.**

Challenges to internationalisation of currency

- **May result in the potential increase in volatility of its exchange rate** in the initial stages.
- **Might have monetary policy implications** as the obligation to supply currency to meet the global demand may come in conflict with its domestic monetary policies, popularly known as the Triffin dilemma.
- **May accentuate an external shock,** given the open channel of the flow of funds into and out of the country.
- Macroeconomics and political stability, and sustaining confidence in the currency's long-term purchasing power.

Initiatives taken by India

- **Indo-Nepal Remittance Facility Scheme.**
- **Bilateral Swap Arrangements (BSA)** with Japan.
- **South Asian Association for Regional Cooperation (SAARC) swap framework.**
- **Arrangement for Bilateral Trade Payments between India and Iran.**
- INR as a **Designated Foreign Currency in Sri Lanka.**
- **Use of Indian Payment Infrastructure** in other jurisdictions etc.
- **Others:** allowing issuance of offshore Rupee-denominated 'masala' bonds; allowing Rupee derivatives to be traded in International Financial Services Centers (IFSCs) etc.

Way forward

- **Promoting international use of INR** by initiatives such as Swaps and Local Currency Settlement, Sufficient INR Liquidity, INR-denominated payment mechanism for cross-border transactions, Creation of an Indian Clearing System, Becoming part of Continuous Linked Settlement etc.
- **Strengthening the Financial Markets** by harmonisation of KYC norms of RBI and SEBI, Promoting India as the hub of INR transactions, Inclusion of Indian Government Bonds in Global Bond Indices etc.
- **Liberalising the capital account** by reviewing extant regulations and guidelines, settling all permissible capital and current account transactions also through offshore INR accounts etc.

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