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Internationalising the rupee

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Why in News: India is aiming to make the rupee a global currency. Pushing for a roadmap towards the internationalisation of the rupee, the Reserve Bank of India's (RBI) inter-departmental group (IDG) recently said with India remaining one of the fastest-growing countries and showing remarkable resilience in the face of major headwinds, the rupee has the potential to become an internationalised currency.

Internationalisation of the rupee

Internationalisation is a process that involves increasing the use of the rupee in cross-border transactions.

It involves promoting the rupee for import and export trade and then other current account transactions, followed by its use in capital account transactions. These are all transactions between residents in India and non-residents.

The internationalisation of the currency, which is closely interlinked with the nation's economic progress, requires further opening up of the currency settlement and a strong swap and forex market.

More importantly, it will require full convertibility of the currency on the capital account and cross-border transfer of funds without any restrictions. India has allowed only full convertibility on the current account as of now.

Currently, the US dollar, the Euro, the Japanese yen and the pound sterling are the leading reserve currencies in the world. China's efforts to make its currency renminbi has met with only limited success so far.

The relevance

Currently, the US dollar is said to enjoy an 'Exorbitant Privilege', which refers to the innumerable benefits that accrue to the US on account of all other countries of the world using the US dollar as their currency in most of their international transactions, among global currencies.

The dollar's position is supported by a range of factors, including the size of the US economy, the reach of its trade and financial networks, the 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.

According to the RBI's working group, the obvious challenger to the US dollar dominance is the Chinese Renminbi.

However, its ability to rival the US dollar will depend on future policies in both the US and China and the ability of the Chinese economy and its financial system to demonstrate the same long-term resilience, integrity, transparency, openness and stability, which are characteristics of the US economy.

In the wake of the sanctions imposed on the Russian government, its public sector and even individuals linked to the government, many countries have become cautious of the price they may have to pay if they are subjected to similar sanctions by the Western governments.

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China, Russia and a few other countries have become more vocal in questioning the US dollar-dominated global currency system.

They would like to reduce their reliance on the US dollar and its financial markets as well as their dependence on dominant international payment mechanisms based on the Society for Worldwide Interbank Financial Telecommunications (SWIFT) messaging system.

While the Asian crisis of 1997-1998 underscored the necessity of emerging market economies having strong foreign exchange reserves to manage external shocks, in an increasingly polarised world, it no longer seems a sufficient defence against the threat of economic sanctions.

The RBI-appointed group feels that it is imperative for India to continue exploring alternatives to both the USD and the Euro.

Advantages of internationalisation of the rupee

The use of the rupee in cross-border transactions mitigates currency risk for Indian businesses.

Protection from currency volatility not only reduces the cost of doing business, it also enables better growth of business, improving the chances for Indian businesses to grow globally.

While reserves help manage exchange rate volatility and project external stability, they impose a cost on the economy.

Internationalisation of the rupee reduces the need for holding foreign exchange reserves. Reducing dependence on foreign currency will make India less vulnerable to external shocks.

As the use of the rupee becomes significant, the bargaining power of Indian businesses would improve, adding weight to the Indian economy and enhancing India's global stature and respect.

The recommendations

The working group, headed by RBI Executive Director Radha Shyam Ratho, has recommended a slew of short to long term measures to accelerate the pace of internationalisation of the rupee.

For the short term, the group has suggested adoption of a standardised approach for examining the proposals on bilateral and multilateral trade arrangements for invoicing, settlement and payment in the rupee and local currencies, encouraging the opening of the rupee accounts for non-residents both in India and outside India and integrating Indian payment systems with other countries for cross-border transactions.

It suggested strengthening the financial market by fostering a global 24×5 rupee market and recalibration of the FPI (foreign portfolio investor) regime.

Over the next two to five years, the group has recommended a review of taxes on masala (rupee-denominated bonds issued outside India by Indian entities) bonds, international use of Real Time Gross Settlement (RTGS) for cross-border trade transactions and inclusion of Indian Government Bonds in global bond indices.

For the long term, the group has recommended that efforts should be made for the inclusion of the rupee in IMF's (International Monetary Fund) SDR (special drawing rights).

The SDR is an international reserve asset created by the IMF to supplement the official reserves of its member countries.

The value of the SDR is based on a basket of five currencies — the U.S. dollar, the euro, the Chinese renminbi, the Japanese yen, and the British pound sterling.

The Way Ahead

The government's road map for further internationalisation of the rupee will make it easier for Indian businesses to do business/invest abroad and enhance the rupee's liquidity, while enhancing financial stability. It must also benefit Indian citizens, enterprises and the government's ability to finance deficits. It is a delicate balance to trade off rupee convertibility for exchange rate stability. One hopes predictable currency management policies will be instituted.