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INTERNATIONALISING THE RUPEE WITHOUT THE 'COIN TOSSING'

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'A start could be made to push for making the rupee an official currency in international organisations' | Photo Credit: Getty Images

The government's announcement of a long-term road map for further internationalisation of the rupee can turn out to be a positive exercise. In the 1950s, the Indian rupee was legal tender for almost all transactions in the United Arab Emirates (UAE), Kuwait, Bahrain, Oman and Qatar, with the Gulf monarchies purchasing rupees with the pound sterling. In 1959, to mitigate challenges associated with gold smuggling, the Reserve Bank of India (Amendment) Act was brought in, enabling the creation of the "Gulf Rupee", with notes issued by the central bank for circulation only in the West Asian region. Holders of the Indian currency were given six weeks to exchange their Indian currency, with the transition happening smoothly. However, by 1966, India devalued its currency, eventually causing some West Asian countries to replace the Gulf rupee with their own currencies. Flagging confidence in the Indian rupee's stability combined with an oil-revenue linked boom, slowly led to the introduction of sovereign currencies in the region. The move, in 2023, to withdraw the 2,000 note has also impacted confidence in the rupee.

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 rupee's internationalisation cannot make a start without accounting for the concerns expressed by India's neighbours.

The rupee is far from being internationalised — 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 ~2%. 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 ~18 countries in rupees instituted. However, such transactions have been limited, with India still buying oil from Russia in dollars. Ongoing negotiations with Russia to settle trade in rupees have been slow-going, with Russia expected to have an annual rupee surplus of over $40 billion — reports indicate that Russian banks have been averse to the trade, given the risk of further currency depreciation and a lack of awareness among traders about local currency facilities. In short, there is very little international demand to trade in the Indian rupee.

For a currency to be considered a reserve currency, the rupee needs to be fully convertible,

readily usable, and available in sufficient quantities. 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.

China's example in internationalising the Renminbi has lessons. As an online article highlights, before 2004, the RMB could not be used outside China. By 2007, the "Dim Sum" bond and offshore RMBD bond market had been created, with financial institutions in Hong Kong allowed to issue dim sum bonds by 2009. Post 2008, China pursued a phased approach, enabling the use of the RMB for trade finance (i.e., financial instruments for facilitating international trade and commerce), investment and, over the long term, as a reserve currency.

First, it allowed the use of RMB outside China for current account transactions (e.g., commercial trade, interest payment, dividend payments) and for select investment transactions (e.g., foreign direct investment, outward direct investment). By 2009, China had signed currency swap agreements (i.e., an exchange of an equivalent amount of money, but in different currencies) with countries such as Brazil, the United Kingdom, Uzbekistan, and Thailand. Soon, it allowed central banks, offshore clearing banks and offshore participating banks to invest excess RMB in debt securities. The Shanghai Free Trade Zone was launched in September 2013, to allow free trading between non-resident onshore and offshore accounts.

Over time, the RMB was internationalised, with reserve currency status increasingly enabled (e.g., by Q2 2022, the RMB's share of international reserves had reached ~2.88%), as the article highlights.

Many reforms can be pursued to internationalise the rupee. It must be made 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. Additionally, the RBI should pursue a deeper and more liquid rupee bond market, enabling foreign investors and Indian trade partners to have more investment options in rupees, enabling its international use. Indian exporters and importers should be encouraged to invoice their transactions in rupee — optimising the trade settlement formalities for rupee import/export transactions would go a long way. Additional currency swap agreements (as with Sri Lanka) would further allow India to settle trade and investment transactions in rupees, without resorting to a reserve currency such as the dollar.

Additionally, tax incentives to foreign businesses to utilise the rupee in operations in India would also help. The RBI and the Ministry of Finance must ensure currency management stability (consistent and predictable issuance/retrieval of notes and coins) and improve the exchange rate regime. More demonetisation (or devaluation) will impact confidence. A start could be made to push for making the rupee an official currency in international organisations, thereby giving it a higher profile and acceptability. The Tarapore Committees' (in 1997 and 2006) recommendations must be pursued including a push to reduce fiscal deficits lower than 3.5%, a reduction in gross inflation rate to 3%-5%, and a reduction in gross banking non-performing assets to less than 5%.

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.

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