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The Rupee as an International Currency

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The internationalisation of the rupee is inevitable as the Indian economy grows. But currency internationalisation cannot be decided on one day and pursued the next. It comes about after a long evolutionary process when all the building blocks are in place, of which financial stability is paramount.

In the recent past, discomfort with the dominance of the US dollar in the global financial system has grown, especially after the Global Financial Crisis of 2008. Post the Global Financial Crisis, China embarked on internationalisation of its currency, the renminbi (RMB). The RMB was included in Special Drawing Rights (SDR) basket of the International Monetary Fund (IMF) in 2016. In 2022, the IMF raised the RMB's weightage to 12.28% from 10.92% in its review of the SDR evaluation.

There are expectations that India could also make a bid to include the rupee in the SDR basket. However, the costs and benefits need to be weighed before a policy decision is taken in this regard.

More recently, financial sanctions were imposed by the US on Russia in the context of the Ukraine war. In view of these developments, India has also initiated the process of invoicing its trade transactions in rupees. This raises further expectations of internationalisation of the rupee. Hence, it may be necessary to review the evolution of the rupee as an international currency and its prospects.

What is an international currency?

An international currency is one that is used and held beyond the borders of the issuing country, not merely for transactions with that country's residents, but also for transactions between non-residents. In other words, an international currency is one that is used instead of the national currencies of the parties directly involved in an international transaction, where the transaction in question involves a purchase of goods, services or financial assets.

An international currency attracts significant volumes of international trades across regions by way of invoicing in that currency. In addition, the currency has to possess a greater degree of stability in its exchange rate as determined by market forces and a deep and liquid market, with availability of wide range of hedging products with easy accessibility to both residents and non-residents. It would also require an efficient banking system and world class market infrastructure. Capital account convertibility and development of offshore centres are other enabling conditions for internationalisation.

Economic fundamentals such as the economy's size and trade network, the depth and liquidity of capital markets, as well as the stability and convertibility of the currency are important determinants that support currency internationalisation. The depth and liquidity of financial market is a very important element in internationalisation as it provides borrowers and investors access to deep and liquid financial markets onshore, which is essential to allow hedging of currency and credit risks that is required by participants in international markets.

Two well-identified advantages are expected from an international currency. First, there are microeconomic gains due to lower transaction costs. Second, the monetary authority issuing an international currency has larger seigniorage revenues. The seigniorage gains are, however, relatively small and are estimated to amount to less than 0.05% of GDP for the Euro area and about 0.1% of GDP for the United States. The other benefits of currency internationalisation include an increase in growth by facilitating greater degree of integration both in terms of foreign trade and international capital flows, savings on foreign exchange transactions, reduced foreign exchange exposure, and economies of scale.

Internationalisation of the domestic currency has several serious potential disadvantages. A major problem with the internationalisation of a currency is that it can increase the potential of the issuing country's vulnerability to external shocks. If large amounts of domestic currency are held by non-residents, particularly at offshore locations, any expectation that the currency is vulnerable due to weak fundamentals, can turn out to be self-fulfilling and may lead to a sell-off resulting in a sharp fall in the value of the currency. Sudden withdrawal of short-term funds and portfolio investments by non-residents is another risk.

Types of currencies

One needs to distinguish between a reserve currency, an accounting currency, and a payment currency. A payment system is different altogether.

A reserve currency is one that is used as a store of wealth, which should be readily available for use by public authorities, and in particular central banks.

A payment currency is one in which a payment is made in a transaction between two parties. The actual currency in which the transaction is to be conducted is an option that the parties can decide on when drawing up the contract.

An accounting currency is one used for an accounting of transactions between the two parties. This can be converted into one or the other currency depending on the requirements of the interested parties.

A payment system is different from an individual payment currency. The payment system can be a national payments system or a global payments system. A national payments system is where payments instructions are exchanged in an encrypted manner and are settled on RTGS basis or 'net' settled. A clearing house for cheques is an example of a net settlement payment system. The London Clearing House is an example of a global payments system and SWIFT is an example of the payments messaging system.

A foreign exchange market is where currencies are traded against each other and the value or exchange rate of the currency is determined in these markets. In a freely floating exchange rate system, currencies that are freely convertible trade actively in foreign exchange markets so that there is sufficient trading to determine the values of those currencies. The number of participants and volumes of transactions determine the depth and liquidity of these markets.

It is generally agreed that payment systems involve common rules and procedures that support the transfer of funds between people, businesses and financial institutions. Since these transfers involve different persons and entities holding accounts with different banks or account holding institutions, a payment system needs to use an intermediary – known as a settlement agent or clearing and settlement agent – for the final settlement of funds between providers. Accounting takes care of properly recording these settled transactions in the books of the concerned entities.

International experience

The pound sterling was the first international currency in modern times, primarily driven by Britain’s dominance in international trade and investment in the 19th century. Subsequently, the US dollar emerged as a major international currency driven by the strength of the US economy and its share in global business, which was further consolidated by the dollar’s emergence as the only significant currency to remain fully convertible after the Second World War. The US dollar continues to be the dominant international currency due to the highly developed and liquid markets that exist in the US dollar instruments. The Swiss Franc was at one time disproportionately important as an international currency, primarily as a safe haven for savings, rather than having a major role in international trade or resource mobilisation.

The euro’s emergence as an international currency is unique. None of the currencies which have merged to form the euro were previously significant international currencies in any significant manner. The deutschemark was considered to have the potential for such a role, but the German fiscal and regulatory regimes tended to discourage it. Even though the euro is currently not the dominant international currency, it has become an alternative to the US dollar as a reserve currency.

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The internationalisation of the Australian dollar took a long evolutionary process. Between 1971 and 1983 Australia faced several problems, but they persisted with reforms. Capital controls were dismantled in 1983 after many years of currency pegging and the currency became a floating currency. The Australian dollar has been an international currency since 1983.

China, in response to the Global Financial Crisis, embarked on an ambitious project of 'Renminbi internationalisation' with the coupled goals of international monetary reform and diversification of global currency risk by internationalising its currency. China has put in a lot of effort for several years to make the yuan a global currency. Resultantly, more than 7% global transactions were done through the yuan during 2022 as per the BIS Triennial Survey, making it the fifth-most traded currency in 2022.

Singapore is a major international financial centre and ranks high in the BIS Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity. The government of Singapore, however, did not pursue a deliberate policy to use the Singapore dollar as an international currency.

In Asia, various degrees of currency internationalisation are already present. The yen, the Australian dollar, and the renminbi are already used extensively in international transactions.

> It is an open question whether public policy should attempt to promote the internationalisation of the domestic currency beyond establishing preconditions such as a deep and dynamic domestic financial market, a well-respected legal framework for contract enforcement.

Capital account convertibility and currency internationalisation are two distinct concepts. Liberalisation of controls on capital account transactions must logically precede attempts to increase the international role of a currency. The benefits from currency internationalisation that go beyond the benefits of capital account liberalisation could include a wider investor base, risk management opportunities as a result of the possibility of issuing debt on the international market in one's own currency, and lower transaction costs resulting from a larger size of the market involving the domestic currency.

Although these gains are genuine, it is an open question whether public policy should attempt to promote the internationalisation of the domestic currency beyond establishing preconditions such as a deep and dynamic domestic financial market, a well-respected legal framework for contract enforcement, and stable and predictable macro and microeconomic policies.

Idea of rupee internationalisation

Prior to Independence, the Indian rupee traditionally enjoyed wide currency in the Persian Gulf. The Indian rupee was regarded as an official currency of several countries including Kuwait, Bahrain, Oman, Qatar, the Trucial States (present-day United Arab Emirates), and Malaysia.

When independence was achieved in 1947, India started off with a comfortable foreign exchange position. The scarcity situation brought about by development and other demands that ensued led to the possibilities of exploiting the traditional currency arrangements with the Gulf. To obviate or at least mitigate malpractices, a separate series of notes exclusively for circulation in the Gulf (Kuwait, Bahrain, Qatar, and the Trucial States) were issued by the Indian government and the Reserve Bank of India in the 1950s. These notes were withdrawn over a period of time from the early 1960s and ceased to be used around 1970 when the Gulf states issued their own currencies.

It can be said that the rupee was an international currency to some extent prior to Independence. Subsequently, there were severe restrictions on the conversion of rupees into foreign exchange or vice versa, both for trade or travel or remittance etc. (current account) and holding or sale or acquisition of financial or physical assets (capital account) both for residents and as a consequence, non-residents also.

Foreign exchange controls 1939-2003

A rigorous foreign exchange control regime owes its origin to the Defence of India Rules 1939. A separate Foreign Exchange Regulation Act (FERA), 1947 was introduced after the Second World War to ration the scarce foreign exchange for all external payments. India faced an acute foreign exchange crisis in the 1960s due to import of foodgrains. The Foreign Exchange Regulation Act, 1973 was enacted, in terms of which all transactions in foreign exchange including those between residents and non-residents were prohibited, unless specifically permitted. India's Green Revolution, and remittances from diaspora Indians reduced the foreign exchange scarcity. Liberalisation of the exchange control regime began in the mid-1980s.

The balance of payments crisis of 1991 showed that rigorous controls and forex regulations do not insulate an economy from crises. The June 1993 recommendations of a high level committee on balance of payments under the chairmanship of C. Rangarajan provided the basic framework for policy changes in the external sector, encompassing exchange rate management and current and capital account liberalisation. Based on the committee's recommendations, a transitional phase of dual exchange rate system, called the Liberalised Exchange Rate Management System (LERMS) was introduced in March 1992. There was a convergence of dual exchange rates to a unified exchange rate in March 1993.

Keeping in view the changed environment, the Foreign Exchange Management Act (FEMA) was enacted in 1999 to replace FERA. The express objective of FEMA was to facilitate external trade and payments (not conservation of foreign exchange) and promote orderly development and maintenance of the foreign exchange market in India. Under FEMA, current account transactions were freely permitted (unless restricted by law) but capital account transactions were subject to regulation. The rupee became gradually convertible on the capital account for specified cases or users.

Real freedom for individuals to draw upon some foreign exchange without any serious restrictions was left to the announcement by the then Finance Minister Jaswant Singh in Mumbai in 2003.

Present status

Currently, the Indian rupee is not freely convertible and cannot be bought or sold in global markets freely. Speculative buying or selling of the rupee without a corresponding underlying trade in goods or services is not permissible as per Indian law. Buying and selling the underlying asset denominated in rupees depends on the prevailing policy regarding acquisition of Indian rupee assets by non-residents. However, trade in rupee-denominated assets outside the country cannot be controlled by the Indian government. Capital account convertibility and the progress towards full capital account convertibility has remained slow for India. While foreign investment flows, especially direct investment, are encouraged, debt flows in the form of external commercial borrowings are generally subject to ceilings and with some end use restrictions.

The calibrated approach to capital account liberalisation is accompanied by continued growth in the foreign exchange markets and offshore markets. As per the BIS Triennial Survey 2022 data, daily turnover in the domestic foreign exchange market increased to $50 billion in 2022 from an average of $3 billion in 2001. Foreign exchange spot transactions contracts rose to $24.5 billion from $1.5 billion over the same period. The rapid expansion of the rupee’s trade within the country and abroad has led to a more than ten-fold increase in its share in the turnover of the global foreign exchange market: to 2% in 2022 from 0.2% in 2001 .

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There is buying and selling of Indian currency in the offshore non-deliverable markets (where the price differences are settled in dollars) to take a position on the rupee for speculative or other purposes. The turnover in offshore markets for the Indian rupee has outpaced that of the onshore market, emphasising that there may be some other elements of internationalisation of the rupee even if our law does not recognise it.

India’s approach

IMF’s articles of Association 1944 included only “avoidance of restrictions on payments for current account transactions” and did not have capital account convertibility as a goal or obligation for the member countries. The Madrid Declaration of the Interim Committee of the IMF in October 1994 welcomed the growing trend towards currency convertibility and encouraged member countries to remove impediments to the flow of capital.

However, the Asian Financial Crisis highlighted the risks of capital outflows, especially to the exchange rates and developing countries. Following the Asian Financial crisis, the IMF’s advocacy of capital flows and convertibility became subdued.

Policy advocacy for globalisation of finance in general and capital account convertibility in particular has declined world over following the Global Financial Crisis of 2008. While acknowledging that rapid capital inflow surges or disruptive outflows can create policy challenges, IMF stated in 2012 that capital flow liberalisation is generally more beneficial and less risky if countries have reached certain levels or thresholds of financial and institutional development. The IMF also recognised that elements of capital controls could provide room for making macroeconomic policy adjustments and be useful in dealing with financial stability.

Masala bonds

Masala bonds are debt instruments issued outside India by an Indian entity or corporate. As these bonds are issued in Indian rupees, the investor needs to bear the exchange rate risks. They provide issuers an alternative to raising debt capital through external commercial borrowings (ECBs), which are repaid in dollars or other currencies. Masala bonds eliminate the currency risk an issuer – for instance an Indian corporate – is exposed to due to fluctuations in the exchange rate while borrowing through the foreign currency ECB route. The bonds issued by residents (and non-residents for repatriation and end use in India as approved by RBI and the government) and held by non-residents are issued under Indian regulations. Masala bonds issued by non-residents and held by non-residents – wherein the proceeds are not repatriated for investment in India – are not governed by Indian regulations.

The International Finance Corporation (IFC) issued masala bonds first in November 2014 for Rs 1,000 crore to fund infrastructure projects in India. Subsequently, IFC, HDFC, NTPC, Kerala Infrastructure Investment Fund Board, and Canada's British Columbia issued masala bonds during 2015–2019.

Have masala bonds been successful? Despite several measures taken by the government to popularise these bonds, the results have been modest. Only a handful of corporates and entities have issued masala bonds so far since their inception in 2014. Issues concerning macro-economic stability, especially the banking system, corporate governance, volatility of the exchange rate, etc. have resulted in higher cost of borrowing to the corporates, compared to borrowing domestically or even through ECBs.

Sovereign bonds

The union finance minister announced in the 2019–20 budget that "India's sovereign external debt to gross domestic product is among the lowest globally, at less than 5%. The government would start raising a part of its gross borrowing programme in external markets in external currencies. This will also have a beneficial impact on the demand situation for the government securities in the domestic market."

Issuance of rupee-denominated sovereign bonds overseas enables internationalisation of the rupee by setting the benchmark sovereign yield curve overseas to help investors price the debt instruments of other corporate entities issued abroad and denominated in rupees, i.e., masala bonds. Sovereign bonds issuance can also boost the confidence of global investors in the Indian economy and this might reduce the cost of borrowing to the corporates.

Several scholars have, however, expressed reservations about the proposal and called for a review of the idea. Sovereign foreign currency borrowing can be rupee-denominated or foreign currency denominated. Just like masala bonds, which are issued by non-sovereign entities, the government issuing masala bonds may not directly expose the country to foreign exchange risk. However, foreign exchange risk devolves upon the sovereign when foreign currency-denominated sovereign bonds are issued. Unlike some of the other emerging market economies, which are forced to borrow in foreign currency due to their inability to issue local-currency debt abroad, India has been able to raise public debt domestically so far without any undue pressure on interest rates.

Issuing foreign currency-denominated sovereign debt is fraught with currency risk, and based on the experience of Asian Financial Crisis 1997 and that of several Latin American countries, it is quite evident that in a globalised world, currency crises are very common and exposing sovereign borrowing to such currency crises would be very risky. The benefits put forth in favour of foreign currency denominated sovereign borrowing, such as setting a bench mark yield for other domestic borrowers in the off-shore market, a lower cost of borrowing and diversification of risk do not appear to be commensurate with the underlying risks and hidden costs.

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It is also argued that India's external debt to GDP ratio is very low and there is some room for such external borrowing. However, such external borrowing, if unchecked, would push the country into a currency crisis during the periods of instability. The lessons from the European sovereign debt crisis should not be easily forgotten.

Overall, it is possible to justify the issuance of sovereign bonds in economic terms in a narrow technical sense. However, in view of the current status of the global financial architecture and domestic political economy considerations, there are serious risks of issuing sovereign bonds at this stage.

The government appears to have kept the proposal to issue sovereign bonds abroad on hold, allowing more time to focus first on achieving the pre-conditions for capital account convertibility and then on internationalisation of rupee, before issuance of sovereign bonds.

Bilateral trade arrangements and rupee invoicing

During the 1950s and 1960s, India entered into bilateral trade agreements with Yugoslavia, Czechoslovakia, Hungary, Poland and others for promoting trade with the rupee as a unit of account. While the effort was to balance the trade, the imbalances were settled in sterling or a convertible currency. In 1958–59, the payments arrangements were changed for making payments in rupees and no demand was to be made for payment of the balance amount in convertible currencies.

Similarly, in 1953, India entered into an agreement with the Soviet Union, in which all payments between India and the USSR were to be made in Indian rupees through bank accounts maintained with commercial banks and RBI. However, the rupee trade ended up being a disadvantage for India on account of various reasons such as the setting of artificially high rupee-rouble exchange rates, switch trades, and the inability to find exporters in Russia who would agree to sell goods under the agreement in rupees (though they were agreeable to selling in hard currencies). A similar arrangement was put in place for bilateral rial-rupee payment arrangement for bilateral trade between India and Iran in 2012.

In July 2022 the RBI looked to boost rupee trade by putting in place an arrangement facilitating invoicing, payment, and settlement of exports and imports in rupees. Under the rupee trade arrangement, banks of trading partners are allowed to open special rupee vostro accounts for the purpose of settling both exports and imports. Any leftover balances in the accounts can be invested in the domestic markets. This measure is expected to provide an impetus to cross border trade transactions in rupee and might contribute to the internationalisation of the rupee, due to wider acceptance of the rupee in global trade transactions.

With the world moving towards a multi-polar system where India could stand as a dominant player, promotion of rupee-based settlement in both international trade and financial markets is expected to attract more global players. The Russia-Ukraine war and the consequent disruptions in payments provides a good opportunity for export settlement in rupees, beginning with some of the smaller export partners. A strong foreign exchange market with an efficient swap market is a big boost for rupee internationalisation. A further improvement in overall economic fundamentals, financial sector health, followed by an upward movement in sovereign ratings will also strengthen confidence in the rupee, making the currency ready for the next step in its international journey.

Lessons and prospects

It is obvious that there are different degrees of internationalisation. By all indications, the rupee is not among the more internationalised currencies.

First, rupee has a very negligible role as a store of value by governments in their official reserves.

Second, the invoicing of trade is an important indicator of the internationalization of the currency. Over 80% of India's exports are invoiced in dollars and around 10% in euros. In regard to imports as well, a little over 90% is accounted for by these two currencies. The use of the rupee is negligible.

As per the latest Triennial Central Bank Survey, the dollar accounts for 88% of global foreign exchange market turnover, followed by the euro (31%), Japanese yen (17%), pound sterling (13%) and renminbi (7%). The rupee accounts for a mere 2%, underlining the need for pushing the currency much farther to get an international tag. In addition, the net International Investment position of India – total external assets minus total external liabilities – continues to be negative and stood at $374.5 billion as of end December 2022.

> The net benefits of internationalisation of currencies, therefore, are not compelling for India to pursue internationalization of the rupee in a hurry.

Third, one indicator of internationalisation of a currency is the size and structure of the forex and the related Over the Counter (OTC) derivatives market. India ranks at around 20 in terms of turnover. However, India finds a prominent place in the share of the non-deliverable forwards (NDF) markets. The NDF market is a market unique to emerging market economies with capital controls.

Fourth, in terms of foreign currency reserves, the dollar continues to be a favourite with over two-thirds of forex reserves of all countries held in this currency. One-fifth is held in euros. Currencies other than the pound sterling and Japanese yen, constitute less than 10%. The Indian currency is held in the reserves of very few countries – six out of 130 – whereas the big four – the dollar, euro, yen and pound sterling – are held by more than 100 of the 130 countries.

Finally, the net benefits of internationalization of currencies, therefore, are not compelling for India to pursue internationalization of the rupee in a hurry. Internationalization of the rupee is likely to be more an outcome of sustained development of the financial system and improved economic performance.

The way forward

The internationalisation of the rupee is inevitable as the Indian economy grows bigger, but there are associated problems. The recent step of invoicing international trade transactions in the rupee is a step in the direction of internationalisation, though the measure has not yet taken off in any significant manner. There are reports that the government is considering incentives for trades using rupee invoicing. It is not very surprising that results are slow on this front.

The experience of other countries highlights that currency internationalisation cannot be decided in one day and pursued the next. It comes about after a long evolutionary process, when all the building blocks are in place. Financial stability is paramount to India and it is pursued as such by the policy makers and the RBI. For India, currency internationalization is expected to evolve steadily and in its own time.

> The experience of other countries highlights that currency internationalisation cannot be decided in one day and pursued the next. It comes about after a long evolutionary process.

The evolution of the international role of the euro, the yen, and the Australian dollar suggests that currency internationalisation does not depend on special government encouragement but will take place naturally when the required preconditions are met and if it is to the benefit of economic agents engaged in international transactions. India's approach has been much in line with this empirical evidence. The public policy focus on establishing preconditions such as a deep and dynamic domestic financial market, a well-respected legal framework for contract enforcement, and stable and predictable macro and microeconomic policies, therefore, is to be sustained.

A roadmap for the internationalisation of rupee merits the consideration of policy makers, duly factoring India's eventual resurgence as one of the top three economies of the world in the near future, the competitive advantage of India in the payment and settlement systems, and the evolving global environment, including developments like Central Bank Digital Currencies.

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