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INTERNATIONALISATION OF CURRENCY: THE CASE OF THE INDIAN RUPEE AND CHINESE RENMINBI

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INTERNATIONALISATION OF CURRENCY: THE CASE OF THE INDIAN RUPEE AND CHINESE RENMINBI

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This study examines the recent debate on the need for a new global reserve currency in the context of the recent global financial crisis, which has, to an extent, eroded the confidence in the US dollar as a numero uno global reserve currency and momentum is building up for reforming the international monetary system. Against this backdrop, China is stepping up efforts to find ways to "internationalize" its currency. The study details various issues pertaining to internationalization of renminbi. The study also details the prospects of greater internationalization of the Indian rupee and the various constraints involved in doing so. The paper concludes that it is quite unlikely that dollar will lose its predominance as global reserve currency in the foreseeable future. However, whether the Renminbi realises its potential as an international currency that is in line with the size of the Chinese economy will depend on market choice, Government policies pertaining to financial liberalisation, currency convertibility and also on political elements. The study avers that against the backdrop of volatile capital flows, cautious movement towards internationalising the rupee is in order as the size of the country in terms of GDP, volume of trade as also the turnover in the foreign exchange market when compared with global dimensions is small. However, India needs to take steps to increase the role of the Indian rupee in the region.

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Introduction

The recent global economic downturn, resulting in the US dollar exhibiting continued weakness in the international financial market, has prompted a search for a new global reserve currency with Chinese authorities taking a number of steps to bring about greater internationalization of Renminbi (RMB). China and India are two of the largest and fastest growing economies in the world, which have been relatively less affected by the global financial crisis. The potential of the Renminbi as an international currency is underpinned by the large and fast growing Chinese economy. The evolution of the international role of the renminbi will depend importantly on the pace of the liberalisation of the restrictions on currency convertibility, which is likely to be governed by the authorities' consideration of the associated benefits and costs.

The significant strength exhibited by the Indian rupee in the recent months and continued good performance of the Indian economy has raised the issue for greater internationalization of the Indian rupee, *a la* Chinese Renminbi. The study examines various issues pertaining to the internationalization of these two currencies. Section I examines the concept of internationalization of a currency. Section II examines issues pertaining to internationalisation of the Renminbi. Section III sets out various issues pertaining to internationalization of the Indian rupee. Some Concluding observations are contained in Section IV.

I. Concept of internationalization of a currency

There is no well-established framework to define what is meant by internationalization of a currency. Theoretical discussions, however, give a guideline for understanding what are the functions that an international currency plays. Kenen (1983) gave an early thought on the roles of international currencies. Chinn and Frankel (2005) developed a list of international functions of an international currency. According to them, an international currency has to be capable of playing roles of store of value, medium of exchange and unit of account for both residents and non-residents. More specifically, it can be used for private purposes, such as, currency substitution, trade and financial transaction invoicing and denomination. It can also be used for public purpose as official reserves, vehicle currency for foreign exchange intervention and anchor currency for pegging.

According to Tarapore Committee on Fuller Capital Account Convertibility (CFAC):

An "international currency" is a currency that is widely used for international transactions, such as the US dollar, Euro, British Pound, Swiss Franc and Japanese Yen. The "internationalisation" of a currency is an expression of its external credibility as the economy integrates globally. In practical terms, it would mean the use of the currency for invoicing and settlement of cross-border transactions, freedom for non-residents to hold financial assets/liabilities in that currency and freedom for non-residents to hold tradable balances in that currency at offshore locations. Some degree of internationalisation can coexist with capital controls.

II. Internationalisation of Chinese Renminbi

(a) Background

Against the backdrop of the recent global economic downturn and the ballooning size of national debt of USA, the idea of a new global reserve currency has been floated. The recent global financial crisis has dented the confidence in the US dollar and momentum is building up for reforming the international monetary system. Some have debated that euro could emerge as a global reserve currency, while others have advocated Chinese Renminbi as a new global reserve currency. Meanwhile, China has become concerned that its enormous foreign exchange reserves, primarily invested in US Treasury securities, are exposed to significant risk. Chinese authorities are faced with a pressing need to revise their investment strategy. Against this backdrop, China is stepping up efforts to find ways to "internationalize" its currency.

“Internationalization of the Renminbi” refers to increasing the extent of its use in China’s cross-border transactions and in overseas transactions in general, and increasing the volume of Renminbi-denominated assets held by non-residents. More specifically, it refers to expanding the role of the Renminbi in the international monetary system and increasing the weight of the Renminbi in current account transactions, capital account transactions, and foreign reserve holdings. According to an estimate, the Chinese hold over $1.7 trillion in dollar assets, out of about US$ 2.6 trillion in foreign assets. Skeptics believe the RMB is a long way from international “safe haven” status as it is not convertible yet and its stability is due, in part, to its dollar peg.

China’s fast economic growth and its increasing economic integration with the world have reinforced its influence in the world economy in the past three decades. During Asian financial crisis of 1997-98, China was praised as a big country with responsible reaction to region-wide currency deprecation for keeping its currency stable. It was the first time that China, as well as its neighboring Asian countries, started realizing China’s emerging influence in Asia. In a broad range of global financial events, China is no longer an outsider. This is not only because China holds largest share of foreign reserves of the world, but also because China’s increasing financial integration with the world enables China’s domestic development and its policy choices to have stronger external effects than ever before. Such development has raised consideration of the possibility of Chinese currency’s internationalization.

Another background for the rise of the issue of the Renminbi internationalization is that current financial crisis reveals the pitfalls of existing international monetary arrangements. Since the collapse of Bretton Woods system in 1973, the US dollar’s status as an international currency has been reinforced on account of the following factors: First, over the past decades, the dollar’s share in overall reserves has declined on a very limited scale. The share of Japanese yen’s has declined over time, whilst the euro has gained limited ground compared with Deutsch mark since its launch in 1999. Second, in international foreign exchange markets (both traditional and derivatives), dollar transactions have accounted for a dominant share over the past decades, which reflects the fact that the US dollar has continuously overwhelmingly dominated the financial transactions and has been the most important currency for government intervention. Third, being an anchor currency, the US dollar plays the role in several ways. While dollarization is one extreme, the other extreme is dollar being either an explicit or implicit pegging currency. In Asia, the phenomenon of dollar over-reliance is described by McKinnon and Schnabl (2004) as "East Asian dollar standard".

Such dollar standard, however, poses risks to international financial stability. It enables the US to become the world's largest debtor and allows it to perpetually run massive current account deficit with the rest of the world. The imbalance correction needs dollar's depreciation, which is a burden on the dollar-asset holders worldwide. Furthermore, dollar's depreciation and worldwide pegging augmented global excess liquidity. The ongoing financial crisis is partly due to the Fed's expansionary monetary policy for years. Emerging countries that pegged their currencies to the US dollar had to adopt similar easy money policy as this type of exchange rate pegging allowed the US to export its monetary policy to the dollar pegging countries. But once the dollar started declining in early 2002, emerging economies were forced to increase their money supply in order to maintain their peg to the weakening dollar. As a result, this kind of synchronized monetary policy enlarged the global excess liquidity. Fragility of dollar standard also arises from over-reliance on the trust in the US's ability of managing the dollar. The traditional gold standard was regarded as the most effective arrangement for countries to keep low and stable inflation, as the supply of gold has its own limitation. The gold-dollar standard under the old Bretton Woods system during 1944-1973 imposed a partial fiscal discipline on the governments. The current dollar standard, however, is basically dependent on the worldwide faith in the US's ability to manage the dollar. There is an inherent danger of a collapse in the confidence reposed in the US dollar on account of sudden developments that affect the US Government's ability to manage the dollar.

Given the above mentioned drawbacks of the dollar dominance, the need for currency diversification is increasingly being felt. The ongoing global financial crisis has brought along an urge to reform the current global financial architecture. One element of the reform proposal package is to consider alternatives to the dollar as international currency. Euro has become one option. It is a moot question whether Chinese Renminbi would be another balancing factor in the dollar dominated international financial regime.

(b) Extent of use of RMB internationally/regionally

A brief summary of current international use of the Renminbi, based on the general roles of an international currency indicated earlier is presented in Table 1. It shows that the Renminbi is neither a currency playing the role of store of value, nor an anchor for public purpose. It also has very limited scope of being used as a medium of exchange in the form of trade and financial transactions invoicing for both residents and non-residents. However, at a very limited level, non-residents have started using Renminbi as a vehicle and an invoicing currency in trade and financial flows.

Table 1: Summary of international/regional use of the Renminbi

Function of RMB	Governments	Private sectors
Store of value	International reserves *None*	Currency substitution *None*
Medium of exchange	Vehicle currency • *payment currency in BSAs (with Korea, Japan and the Philippines) under the CMI* • *bilateral swap arrangement between central banks (with Korea, HKMA, Malaysia, Argentina and Belarus)*	Invoicing currency • *Trade settlement in RMB (with Vietnam, Mongolia, Cambodia. etc)* • *RMB loans in HK* • *RMB bond issuance in HK by policy and commercial banks* • *RMB government bond issuance under ABF2* • *RMB equity issuance (H share)*
Unit of account	Anchor for pegging *None*	Denominating currency

ABF: Asian Bond Fund, BSAs: Bilateral Swap Arrangements, CMI: Chiang Mai Initiative, HKMA: Hong Kong Monetary Authority.
Source: Chinn and Frankel (2005).

begun, some progress is already visible in transactions with its neighboring economies.

First, the Renminbi is being widely used in trade and other current account transactions with Vietnam, Laos, Myanmar, the Central Asian states, Russia, and so forth. Also, with greater number of mainland Chinese tourists visiting Hong Kong and Macau, the Renminbi is now being circulated alongside the respective local currencies. Given this state of affairs, the Standing Committee of the State Council decided at its meeting on December 24, 2008, to launch Renminbi settlement trials for goods traded between the Guangdong-Pearl River Delta area and Hong Kong-Macau, and between the Guangxi-Yunnan region and the Association of Southeast Asian Nations (ASEAN). China also has signed agreements with eight neighboring countries, including Russia, Mongolia, Vietnam, and Myanmar, to allow the settlement of bilateral trade payments in the Renminbi.

Second, with respect to capital account transactions, China has promulgated provisional rules governing the issuance of Renminbi-denominated bonds by international development institutions, thereby allowing non-residents to issue in Chinese markets so-called panda bonds, which are the Chinese equivalent of Japan's samurai bonds. In October 2005, the Asian Development Bank (ADB) and the International Finance Corporation (IFC) issued 10-year Renminbi-denominated bonds worth one billion Renminbi (¥13.2 billion) and 1.13 billion Renminbi, respectively. The IFC launched its second panda bond issue worth 870 million Renminbi in November 2006. At the moment, eligible non-resident issuers are limited to international development institutions. But it is expected that the scope of eligibility will be expanded to include foreign companies.

Third, in regard to its management of foreign exchange reserves since the outbreak of the global financial crisis, the People's Bank of China (PBOC) has entered into a series of bilateral currency swap agreements (BSAs) whereby the PBOC and other central banks have agreed to exchange the Renminbi (not the US dollar) with the respective counterparty currencies. The first such deal was struck with South Korea on December 12, 2008 followed by currency swap agreements with Hong Kong, Malaysia, Indonesia and Belarus. In the first such move involving a Latin American country, China entered into a 70 billion yuan ($10.2 billion) currency swap agreement with Argentina on March 31, 2009 that allows the latter to place yuan-denominated orders for Chinese imports and thereby avoid using the US dollar in bilateral trade. The agreement with Argentina marked China's sixth bilateral currency swap. These inter-central bank arrangements are expected to expand China's trade with its respective partners by providing Renminbi-denominated funds to counterparty countries and regions.

Fourth, in the context of Renminbi's internationalization, Hong Kong aims to become an offshore Renminbi trading center and the Chinese Government is giving full support to the move. In February 2004, banks in Hong Kong formally began accepting Renminbi deposits. Subsequently, in June 2007, the Chinese authorities - i.e., the PBOC and the National Development and Reform Commission - announced provisional rules governing the issuance of Renminbi-denominated bonds by domestic financial institutions in the Hong Kong Special Administrative Region to allow mainland Chinese policy and commercial banks to issue Renminbi-denominated bonds there. Debt issuance in Hong Kong enables mainland Chinese enterprises to raise funds at lower costs than in the mainland market, while allowing Hong Kong investors to earn higher rates of return than on Renminbi-denominated bank deposits. However, at the moment there is a ceiling on the amount of Renminbi bonds that can be issued per year, with eligibility limited to domestic financial institutions. Only investors with Renminbi-denominated bank accounts in Hong Kong are permitted to purchase the bonds. Additionally, Chinese authorities have formulated policies clearly encouraging the issuance of Renminbi bonds in the Hong Kong market by Hong Kong-based enterprises and financial institutions operating in mainland China and supporting the development of Renminbi business in Hong Kong. With effect from September 28, 2009, investors in Hong Kong are able to buy bonds issued by the Chinese government. It may be pointed out in this context that this is the first time that the Chinese government is borrowing money offshore and paying it back in its own currency. According to the Chinese finance ministry, the bond is meant to encourage acceptance of the Renminbi in international transactions and to encourage Chinese companies to tap the territory's debt market. According to analysts, this is a step towards internationalizing the Renminbi.

(c) Prospects of Renminbi becoming reserve currency and likely steps towards Renminbi's Internationalisation

- According to some reports, the use of renminbi to settle trade between selected Chinese provinces and Hong Kong and Macao is expected to commence shortly on a trial basis, reducing currency risk for Hong Kong exporters. Pilot projects will use the Renminbi for projects in Asia. Chinese exporters may also increase forex advances.
- China's currency swaps concluded in late 2008 and early 2009 with six emerging economies could increase use of the RMB beyond its borders. Most of these swaps support trade between these countries.
- Allowing more use of the RMB outside China's borders might increase demand for the currency even if it shifts the burden of exchange rate fluctuation to China's trading partners. These are steps towards the full convertibility and capital account liberalization that would be needed for the RMB to have a global role.
- At the moment, though, the Renminbi is far from ready to achieve reserve currency status. China would first have to ease restrictions on money entering and leaving the country, make its currency fully convertible for such transactions, continue its domestic financial reforms and make its bond markets more liquid. It would take a long time for the Renminbi to become a reserve currency, but the possibility of Renminbi becoming reserve currency sometime in future is not totally unrealistic. China's currency swaps and RMB bonds in Hong Kong are steps along this path.

- A more flexible renminbi, especially one that could have a share in the region's transactions and as a store of value could reduce demand for the US dollar, increase the yields on US treasuries and consequently the cost of financing the US deficit.
- In a trial, China plans to use the renminbi for settlement in some large projects in ASEAN, Hong Kong and Macao, as well as Russia. The losses on foreign exchange transactions have eaten into Chinese exporters' profit in foreign trade and these steps are essentially aimed at reducing such losses.
- State Administration of Foreign Exchange (SAFE) plans to allow Chinese banks to open domestic foreign exchange accounts for overseas institutions. This will also provide foreign exchange accounts for State Owned Enterprises (SOEs) undertaking international investment and merger and acquisitions. Previously, only foreign banks were allowed to open foreign exchange accounts for overseas institutions.
- The Renminbi is likely to become a regional currency because of China's expanding trade links before it gains acceptance as an international reserve currency. To ensure access to China's steadily growing markets, ASEAN may have to settle their transactions in Renminbi. PBoC may have to widen the daily trading band of the Renminbi against the US dollar, now capped at 0.5 per cent per day. After becoming a settlement currency, the next logical step would be for the Renminbi to become a regional reserve currency.

(d) Costs/Benefits to China from Renminbi's Internationalisation

- China is moving ahead with Renminbi internationalization. However, a number of issues still need to be resolved because further progress hinges not only on the expediency for China, but also on the attractiveness of the Renminbi as an international currency for other countries.
- For China, the greatest advantage in Renminbi internationalization is reduced foreign exchange risk for Chinese enterprises. The Renminbi's use in contracts and invoices for international trade and settlements would eliminate

the risk of foreign exchange fluctuations for Chinese exporters and importers, thereby enabling them to save on transactions costs including hedges using futures. Furthermore, enabling Chinese investors to hold Renminbi-denominated foreign assets would eliminate the risk of capital losses resulting from a weaker US dollar. These measures would surely facilitate international trade and capital transactions.

- The Renminbi‘s internationalization will also enhance the international competitiveness of Chinese financial institutions. Chinese banks and securities companies would have competitive advantages over their US and European counterparts in Renminbi business dealings - including loans, trade finance, and the issuance of Renminbi-denominated foreign bonds - and be able to earn higher returns without bearing the cost of foreign-exchange related risks. As a result, both Shanghai and Hong Kong would be able to improve their standing as international financial centers.
- Furthermore, when the Renminbi gains wide acceptance as an international currency, China will enjoy the additional benefit of seigniorage, i.e., the difference between the face value of a currency and the cost of producing it. Like the US today, should this plan become a reality, China could continue exporting foreign goods and services while running current account deficits at the same time simply by printing more money.
- On the other hand one major drawback of Renminbi internationalization would be China‘s increased susceptibility to the inflows and outflows of international hot money. Ensuring the free movement of capital would be a critical prerequisite to the internationalization of the Chinese currency and would reduce the effectiveness of monetary and macroeconomic policies in China.

(e) Prerequisites for Renminbi Internationalisation

- Progress towards Renminbi internationalization depends not only on China’s own cost-and-benefit calculations, but also on the extent to which the following conditions are being fulfilled: First, China’s share in the world economy - whether in terms of gross national product (GNP) or foreign trade - needs to be fairly substantial. Second, global markets must possess sufficient confidence in the value of the Renminbi. Third, China needs to have a well-functioning financial market that can freely and transparently accommodate foreign exchange trading and capital transactions, and its domestic financial market must be equally accessible to both residents and non-residents.

- Some of the major domestic developments, which are indispensable to the success of the Renminbi internationalization include full convertibility of the Renminbi, liberalization of domestic financial system, more flexible Renminbi exchange rate, strengthening China's financial system, development of domestic money, bond and equity markets, setting up of an advanced settlement system, making necessary adjustment to the legal system, etc

- The first and second conditions are gradually being fulfilled, but China has a long way to go before meeting the third condition. A particularly onerous obstacle to Renminbi internationalization is a set of strict restrictions on capital transactions that is currently in place.

- There are demands from certain quarters for accelerating the liberalization of capital transactions to facilitate Renminbi internationalization but it is extremely dangerous to liberalize capital transactions prematurely without paying proper attention to the vulnerability of domestic financial systems, because such an attempt could lead to inflation and subsequent collapse of a bubble.

- Therefore, China needs to pursue a gradual approach to Renminbi internationalization by keeping in step with its liberalization of capital account transactions and the progress of its domestic financial reforms that are prerequisites to such liberalization.

- The development of offshore market and currency internationalization go hand in hand. Currently, although there exist few types of transactions, such as, the Renminbi non-deliverable forwards traded in Hong Kong and some other Asian cities, the Renminbi has not been a standard offshore currency. Before the Renminbi becomes fully convertible, the offshore Renmibi market has to be in place. Without a well developed offshore market, the Renminbi can hardly become an international currency.

- Apart from economic aspects, political elements are equally important for the Renminbi internationalization, which, to a large extent, depends on China's continued rise in the global economy, Japan's reaction to China's increased influence in Asia, and the United State's reaction to China's rise in the world.

(f) Various Stages of Renminbi Internationalisation

Whether the Renminbi realises its potential as an international currency that is in line with the size of the Chinese economy will be a market choice. Government policies in financial liberalisation and currency convertibility could facilitate or inhibit the process. At the early stage, the process of internationalizing the Renminbi can start with boosting cross-border usage of the currency in terms of denominating trade and financial transactions. The region-wide use of the Renminbi shall be the natural outcome of its covering more areas of China's neighboring countries. The Renminbi regionalization can also be a result of policy-driven process by various means, such as, issuing the Renminbi bonds (Government bonds and corporate bonds); encouraging the use of Renminbi as an invoicing currency in China's FTAs; signing up currency swaps (bilateral and multilateral) agreements using the Renminbi as the payment money; increasing use of the Renminbi in regional monetary system. In the medium and long-term, the Renminbi regionalization shall be an inevitable step towards the stage of the Renminbi internationalization.

It may be mentioned in this context that China is actively pushing the idea of setting up a regional monetary fund on the base of ASEAN+3 and also making a strong case for Asian Currency Unit (ACU). According to some economists at Shanghai University, internationalization of RMB is a three-step process. First, RMB will emerge as a common currency of "Greater China" including mainland China, Hong Kong and Taiwan; second, it will become a major component of an Asian Currency Unit and finally, acquire a global profile.

III. Internationalisation of Indian Rupee

(a) Historical Perspective

Historically, the Indian rupee was regarded as an official currency of other countries, including Kuwait, Bahrain, Qatar, the Trucial States (United Arab Emirates (UAE) since 1971) and Malaysia in previous times. The Gulf rupee, also known as the Persian Gulf rupee, was introduced by the Government of India as a replacement for the Indian rupee for circulation exclusively outside the country with the Reserve Bank of India [Amendment] Act, May 1, 1959. This creation of a separate currency was an attempt to reduce the strain put on India's foreign exchange reserves. After India devalued the rupee on June 6, 1966, those countries still using it - Oman, Qatar and UAE - replaced the Gulf rupee with their own currencies. Kuwait and Bahrain had already done so earlier in 1961 and 1965, respectively.

(b) Current Status of Internationalisation of Indian Rupee

Against the backdrop of global financial crisis and sustained weakness of the US dollar in the international market resulting in significant appreciation of the rupee in the recent period, it is quite natural that demand for internationalization of the rupee, especially greater use of rupee for trade invoicing, would increase as in the case of China. In the region, India holds an important position in terms of economic growth and volume of trade. India has a growing role in Asia as an engine of economic growth. It is increasingly getting integrated with East Asian Countries. India's economy of more than a trillion US dollars is growing at a rate of nearly 8 per cent per annum. The value of the Indian rupee is market-determined and not pegged to any currency. India's foreign exchange reserves are amongst the largest in the region. All these factors make the Indian rupee a natural candidate for being considered for greater internationalization.

In this context, the current status of the Indian rupee in regard to meeting various prerequisites for internationalization is set out below:

- Internationalisation of a currency is a policy matter and depends upon the broader economic objectives of the issuing country. There are various policy issues involved, like the extent of capital account liberalisation. India's approach in this context has been reflected in a full but gradual opening up of the current account but a more calibrated approach towards the opening up of the capital account. While foreign investment flows, especially direct investment, is encouraged, debt flows in the form of external commercial borrowings are generally subject to ceilings and with some end use restrictions.
- India, at present, does not permit rupee to be officially used for international transactions except those with Nepal and Bhutan (Bhutanese Ngultrum is at par with the Indian Rupee and both are accepted in Bhutan. The Indian rupee is also accepted in towns of Nepalese side of Nepal-India border). Non-residents cannot hold rupee assets and, more importantly, liabilities denominated in Indian rupee, beyond certain limits.
- The hallmark of any international currency is that invoicing of tradable goods between countries is done in internationalised currency. In sharp contrast, almost the entire bulk of international trade in India continues to be denominated in the US dollars (Table 2). Efforts to promote invoicing in the domestic currency have met with little success in countries with currencies which are not internationalised as the trade-counterparty does not have the necessary infrastructure to hedge his exposure in international markets.
- India accounts for a very small proportion of the total foreign exchange market turnover in the world as compared to other countries. BIS Triennial Central Bank Survey data for 2007 shows that India's daily average share in the total foreign exchange market turnover is 0.9 per cent as compared to 34.1 per cent for the UK and 16.6 per cent for the USA. However, India's share in total foreign exchange market turnover has been slowly but continuously increasing. India's share has increased from 0.1 per cent of the

Table 2: Currency-wise Pattern of Invoicing of India's Foreign Trade				
				(Per cent)
Name of currency	**2005-06**		**2008-09**	
	Export	**Import**	**Export**	**Import**
Pound Sterling	2.87	1.96	2.78	0.88
US$	**87.36**	**78.17**	**84.12**	**86.34**
Japanese Yen	0.51	4.20	0.48	2.29
EURO	7.69	12.48	10.85	9.51

total foreign exchange market turnover in 1998 to 0.2 per cent in 2001 to 0.3 per cent in 2004 to the current 0.9 per cent.

- The share of Indian Rupee in total currency turnover is also very small. Moreover, in case of the Indian rupee, spot transaction accounts for major part of currency turnover (42.6 per cent), while in case of both Euro and Dollar, the foreign exchange turnover is highly concentrated in foreign exchange swaps.
- There is some anecdotal evidence that Indian rupee is accepted in Singapore, Malaysia, Indonesia, Hong Kong, Sri Lanka and the UK. The Central Bank of Nepal, Nepal Rastra Bank, also holds Government of India Treasury Bills.
- There is growing demand for off-shore rupee-linked paper from real money accounts (who are not allowed to hold derivatives), given the caps on foreign investor flows to the Indian local currency debt market. Inter-American Development Bank (IADB) issued the first offshore rupee bond with a 3-year tenor for Rs. 1.0 billion in February 2007. In May 2007, IADB issued another offshore rupee bond with a 10-year tenor for Rs.1.5 billion. The World Bank placed a similar issue in June 2007 for Rs.1.25 billion with a 3-year tenor. European Bank for Reconstruction and Development issued rupee offshore bonds with a 5-year tenor for Rs.1.00 billion in July 2007 (Singh, 2007).
- Internationalisation of currency has often been projected in the literature as one of the benefits of joining a currency union. This is in fact true in the case of Euro. India is, as yet, not considered a part of Asian Currency Unit (ACU). The currencies of the 13 major countries included so far in ACU are – Singapore,

Malaysia, Indonesia, Thailand, the Philippines, Brunei, Laos, Myanmar, Vietnam and Cambodia, plus China, Japan and South Korea (ASEAN +3).

- Joining an international currency union has its merits and demerits. The merits are that such a union may eliminate exchange rate fluctuations and deter speculative attacks, reduction of transaction costs, economies of scale for firms operating in the region and greater trade and financial flows. The demerits are that it could lead to weakening of national sovereignty and limit the national government's power of economic management. However, significant cross-country variations in the size of the economy, stages of development, growth performance, inflation control, degree of openness, and other economic indicators among the ACU countries exist at present and these needs to converge before a union or a currency unit can be considered viable. Being a part of ACU would facilitate the process of internationalization of the rupee, which has not been the case so far.

(c) Implications of Internationalisation of the Indian Rupee

The first and immediate impact of the internationalisation of a currency is the potential increase in volatility of its exchange rate. It also has implications for the conduct of monetary policy. When a currency starts getting used outside national territories, there would be some kind of economic integration with areas where it is actively traded, which in turn stimulates better growth.

When an economy is globally integrating, differences in tax rates and restrictions on use of its currency by non-residents result in development of off-shore non-deliverable forward (NDF) markets for the currency. The development of offshore market and currency internationalization go hand in hand. Currency convertibility and the increasing use of a currency in international pricing, settlement, purchase and payment, are pre-requisites for the development of off-shore market. Meanwhile, offshore market with its own purpose for financial transactions conducted outside the territory of the currency-issuing country and not be subject to the country's jurisdiction is an inseparable part of international use of a currency. An NDF contract is essentially an outright forward contract in differences which is cash settled. The market expectations of the exchange and interest rates of the underlying currency form the basis for arbitrage and/or pressure on domestic markets. The Korean won, Taiwanese dollar and Chinese yuan are reportedly the most-traded Asian currencies in the NDF market.

Presently, a cash market for the Indian rupee exists outside the country, e.g., in the Middle East and in South East Asia. The Rupee NDF market which was not very large or liquid till a few years back has increased significantly in size in the recent period. The size of Rupee NDF market which was reported to be around US$ 100 million per day in 2003-04 has increased to around US$ 800 million in 2008-09 (Table 3). Although export of Indian Rupee currency notes beyond a very modest sum is not permitted, the fact is that a significant amount of Rupees in currency form is held outside the country, particularly in places where there are sizeable expatriate Indian population. This is perhaps some indication of the growing acceptability of the Rupee outside the shores of the country.

A matter of concern is that internationalisation of a currency can greatly accentuate an external shock, given the larger channels and independence to the residents and non-residents with respect to the flow of funds in and out of the country and from one currency to another. If on account of internationalization

Table 3: Average Daily NDF Turnover

(in millions of US dollars)

Sources of estimates	HSBC	Deutche Bank	
	(mid-2003)	(2003-04)	(2008-09)
Chinese Renminbi	1,000	50	1,000
Indian rupee	100	20-50	800
Indonesian rupiah	100	50	400
Korean won	500	700-1,000	3,000
Philippine peso	50	20-30	500
Malaysian Ringitt		–	500
New Taiwan dollar	500	300-500	–
Total	**2,250**	**1,140-1,680**	**6,200**

of the Indian rupee, non-residents hold significant balances of the domestic currency, particularly at offshore locations, any expectation that the country is vulnerable due to weak fundamentals or a contagion would lead to a sell-off resulting in a sharp fall in the currency. Withdrawal of short-term funds and portfolio investments by non-residents can be a major potential risk of internationalization of the Indian rupee.

India has also entered into bilateral swap arrangement with Japan in June 2008, which enables both countries to swap their local currencies (i.e., either Japanese yen or Indian rupee) against US dollar for an amount up to US$ 3 billion. However, unlike the 6 Bilateral Swap Arrangements (BSAs) entered into by China with EMEs, where the use of dollar has been precluded, the arrangement between India and Japan envisages the use of US dollar for swap transactions. If India enters into BSAs and trading arrangements with other EMEs, as in the case of China, involving swap between INR and the currency of its trading partner, it will result into greater internationalization of the Indian rupee.

However, in the context of internationalisation of the Indian rupee, it is imperative to bear in mind that unlike China, which runs a large current account surplus, India generally runs a significant trade and current account deficits. Similarly, its capital account is still relatively not so open, i.e., rupee is not fully convertible for some capital account transactions. In view of the large current account deficit, the exchange rate of the rupee is susceptible to the debilitating influence of large capital movements, especially during crisis period. Since the depth of the Indian financial market is relatively less, such volatile capital flows can impart significant volatility to the Indian rupee. Internationalisation of any currency depends on market forces., i.e., how much faith the market has in that currency, which, in turn, depends on various factors, such as, the size of the economy, level of financial development, stability, etc. However, India needs to take steps to increase the role of the Indian rupee in the region to catch up with the growing influence of Chinese Renminbi.

IV. Concluding Observations

This paper has made an attempt to detail various issues pertaining to the internationalization of the Chinese renminbi and the Indian rupee. The recent global economic downturn and weakness of the US dollar in the international market has prompted a wide-ranging debate on the need for a new global reserve currency. It is quite unlikely that dollar will lose its predominance as global reserve currency in the foreseeable future but the current crisis has thrown open the debate on the need for a new global reserve currency in case the US economy fails to make a significant turnaround and the weakness of US dollar persists making its continuance as a global reserve currency unsustainable.

Among the emerging market currencies, Renminbi and Indian rupee are natural contenders for an international currency status on account of the increasing economic prowess of these countries and their ability to withstand the adverse impact of the global financial crisis with relatively greater ease. Chinese authorities are taking a number of steps to bring about greater internationalization of Renminbi. At present, Renminbi is neither a currency playing the role of store of value, nor an anchor for public purpose. However, at a very limited level, China's endeavor to internationalize the Renminbi has begun as some progress is already visible in transactions with its neighboring economies. Additionally, China has promulgated provisional rules governing the issuance of Renminbi-denominated bonds by international development institutions, thereby allowing non-residents to issue in Chinese markets so-called panda bonds. People's Bank of China (PBOC) has entered into a series of bilateral currency swap agreements whereby the PBOC and other central banks have agreed to exchange the Renminbi (not the US dollar) with the respective counterparty currencies, mainly for supporting trade between these countries. Hong Kong is increasingly becoming an offshore Renminbi trading center and the Chinese government is giving full support to the move.

For China, the greatest advantage in Renminbi internationalization is reduced foreign exchange risk for Chinese enterprises. The Renminbi's internationalization will also enhance the international competitiveness of Chinese financial institutions. Furthermore, when the Renminbi gains wide acceptance as an international currency, China will enjoy the additional benefit of seigniorage. On the other hand one major drawback of Renminbi internationalization would be China's increased susceptibility to the inflows and outflows of international hot money. At the moment, though, the Renminbi is far from ready to achieve reserve currency status. Progress towards Renminbi internationalization depends not only on China's own cost-and-benefit calculations but on China's share in the world economy, confidence of global markets and well functioning financial market in China. Before the Renminbi becomes fully convertible, the offshore Renmibi market has to be in place which is still not there. Apart from economic aspects, political elements are equally important for the Renminbi internationalization. The Renminbi is likely to become a regional currency because of China's expanding trade links before it gains acceptance as an international reserve currency

The significant strength exhibited by the Indian rupee in the recent months and continued good performance of the Indian economy have raised the issue of greater internationalization of the Indian rupee. India's has hitherto followed a calibrated approach towards capital account liberalization. India at present, does not permit rupee to be officially used for international transactions except those with Nepal and Bhutan though there are indications that Indian rupee is gaining acceptability in other countries. There are problems associated with Internationalisation of the rupee as it can increase volatility of its exchange rate. Withdrawal of short-term funds and portfolio investments by non-residents can be a major potential risk of internationalization of the Indian rupee. Unlike China, which runs a large current account surplus, India generally runs a significant trade and current account deficits. Similarly, its capital account is still relatively closed and Indian financial markets lack depth compared to global standards. The Indian rupee is rarely being used for invoicing of international trade. All the necessary preconditions need to be in place before India could proceed further on the issue of internationalization of the rupee. In view of this, India needs to proactively take steps to increase the role of the Indian rupee in the region.

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