Macro Pre-conditions for Rupee Internationalisation

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Outline

1. The Dollar’s international currency status.
2. Efforts by China to internationalize RMB.
3. Macro pre-conditions for Indian Rupee internationalization.
Attributes of an international currency

1. **Scale**: Size of economy, size of international transactions with rest of the world.
2. **Stability**: Confidence in the value of the currency.
3. **Liquidity**: Buying and selling assets without affecting price of the currency.

Measures of currency internationalization

- Share of the currency in countries’ FX reserves.
- Share of the currency in international bonds’ denomination.
- Share of the currency in global trade invoicing.
Bank of England: “conductor of the international orchestra” (Keynes, 1930)
In 1913 the Federal Reserve Act established the central bank in the US.
Early 20th century

- By 1924, Dollar had emerged as an international reserve currency alongside the Pound.
  - Concerted policy reform and institutional innovation can help develop a liquid market needed to support currency internationalization.
- By late 1930s, Dollar surpassed Sterling as a currency of denomination for international bonds.

Figure: Chitu, Eichengreen and Mehl (2014)
Post WW II, international economy organized around the Dollar and was dominated by the US.

In the Bretton Woods System countries pegged their currencies to Dollar which was pegged to gold.

- US provided political stability, financial depth, and financial intermediation.
- US provided deep and liquid financial markets, that were open to the world.
  - This gave the Federal Reserve System leverage over global financial conditions
Figure: Chitu, Eichengreen and Mehl (2014)
Currency Composition of FX Reserves 1999 vs 2010

Market Share of Foreign Exchange Reserves

1999 Q1
- US Dollars: 71.2%
- Euros: 18.1%
- Pounds Sterling: 6.0%
- Japanese Yen: 1.9%
- Other: 2.7%

2010 Q2
- US Dollars: 62.1%
- Euros: 26.5%
- Pounds Sterling: 3.3%
- Japanese Yen: 3.9%
- Other: 4.2%

Source: IMF
US holdings of EME LC bonds

Local currency Holdings - only EMs

- Asia_EMs
- Latin_America_EMs
- Other_EMs
- Asia_EMs_ex_China

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New currency on the block?

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Macro Pre-conditions for Rupee Internationalisation
China and the RMB

Scale:
China is the world's largest trading nation. By 2030, it will account for 28% of global GDP compared to 18% for US. Significantly smaller in terms of international financial transactions, compared to the US.

Stability:
Lack of a political democracy in China could be a challenge.

Liquidity:
Local currency bond market is very small in size. Capital controls are a deterrent.

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Macro Pre-conditions for Rupee Internationalisation
China and the RMB

**Scale:**
- China is the world’s largest trading nation.
- By 2030, it will account for 28% of global GDP compared to 18% for US.
- Significantly smaller in terms of international financial transactions, compared to the US.

**Stability:** Financial, Economic, Political
- Lack of a political democracy in China could be a challenge.

**Liquidity:**
- Local currency bond market is very small in size
- Capital controls are a deterrent.

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- **Scale**
  - Indian economy is 7th largest in the world by nominal GDP ($2.38 trillion).
  - It is the world’s fastest growing major economy since 2014Q4.
  - India has the potential to become the world’s 3rd-largest economy by the next decade.
  - However share of India’s trade in world trade is less than 3%.

- **Stability**
  - Inflation has been declining.
  - Policy credibility is getting established (reduction of fiscal deficit and adoption of inflation targeting).
  - Like all other countries with international currencies, India is a political democracy.

- **Liquidity**

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Challenges for Rupee Internationalization

Liquidity:
- India does not have a deep and liquid bond market.
- Hedging opportunities against all possible risks are limited.
- There continues to exist a comprehensive set of capital controls.
- Exchange rate is in a managed floating regime.

Steps must be taken to facilitate financial development, improve financial stability and liquidity, before internationalization of the Rupee becomes feasible.
Thank you.