Report of the Inter-Departmental Group (IDG) on Internationalisation of INR

This report and its recommendations reflect the views of the IDG and do not in any way reflect the official position of the Reserve Bank of India.

आज़ादी का अमृत महोत्सव

Azadi Ka Amrit Mahotsav

REPORT OF INTER DEPARTMENTAL GROUP ON INTERNATIONALISATION OF INR

RESERVE BANK OF INDIA

OCTOBER 2022

Report of Inter Departmental Group on Internationalisation of INR

RESERVE BANK OF INDIA
OCTOBER 2022

Strength does not come from physical capacity.
It comes from an indomitable will

- Mahatma Gandhi

UTKARSH VISION

To foster confidence in the internal and external value of the Rupee and contribute to macro-economic stability

- RBI Utkarsh 2022

Enhanced relevance and significance in national and global roles

- Vision 3 Utkarsh 2022

TABLE OF CONTENTS

CHAPTERS

LIST OF ANNEXURES

Letter of Transmittal

October 06, 2022

Shri T. Rabi Sankar
Deputy Governor
Reserve Bank of India
Central Office
Mumbai-400001

Dear Sir,

Report of the Inter Departmental Group on Internationalisation of INR

It gives us immense pleasure in submitting the report of the Inter Departmental Group constituted to review the extant position of INR as an international currency and to frame a road map for internationalisation of INR.

We thank you for the confidence reposed in us to look into various gamuts of an issue that is of immense importance as India continues to move up in the league of nations. We hope that the recommendations in the report will help internationalisation of INR in a calibrated and least disruptive manner.

Yours faithfully,

(Radha Shyam Ratho)
Chairman

(Ajay Kumar Misra)
Member

(R. Lakshmi Kanth Rao)
Member

(P. Vasudevan)
Member

(Dimple Bhandia)
Member

(G. Seshsayee)
Member

Aditya Gaiha

(Aditya Gaiha)
Member Secretary

Acknowledgements

The Inter Departmental Group (IDG) wishes to sincerely acknowledge the efforts of all those who have contributed to preparation of the report, drafted in the backdrop of India's rising importance in the global economic landscape and, consequently, the potential for INR to emerge as an international currency. A report on the possible path for internationalisation of a currency has few precedents, and the IDG is grateful to all those who contributed to the thinking on this difficult topic.

The IDG expresses its gratitude to Shri T. Rabi Sankar, Deputy Governor, for entrusting the responsibility of preparing a report on internationalising INR on the Group and providing continuous encouragement as the Group progressed in this task.

The IDG immensely benefitted from the diverse expertise of the members heading various departments, *viz.,* FED, DoR, DPSS, DEIO, FMRD and FMOD, who spared their valuable time and resources while preparing the report. The IDG also acknowledges that in the past there has been continuous thought process and efforts within the RBI on furthering capital account convertibility by implementing various external sector and financial market reforms.

The IDG places on record its appreciation of Shri Sundar Murthi for contributing his inputs and insights to the report. The IDG is also thankful to Shri Vivek Srivastava, Smt. Latha Radhakrishnan, Shri N Senthil Kumar,Shri Saurabh Nath, Shri Saswat Kumar Mahapatra, Shri Amitabh Khandelwal, Shri Manoranjan Padhy, Shri Vivek Singh, Shri Sidharth Prakash, Shri Sachin Sharma, Smt. Mruga Paranjape, Shri Arun Kumar, Shri Nitin Daukiaand Shri Rohit Lohi Das for their inputs. Several consultations were also held with other officers including officers of MPD and DEPR.

The IDG would like to commend the efforts and able assistance rendered by the Secretarial team comprising of Ms. Nishi Moudgil, Ms. Peeyoosh Nag, Shri Mohit Kumar, Dr. Harpreet Singh Grewal, Shri Pravin Kumar, Shri Naveen Kumar, Shri Sabyasachi Sarangi, Shri Gopal Krishna Mukhi, Shri Nikhil Patil and Shri Aniket Ranjan for tirelessly working through various iterations of the report and giving the document a final shape.

Abbreviations

ACU	Asian Clearing Union
AD	Authorised Dealer
AML	Anti-Money Laundering
ASEAN	Association of Southeast Asian Nations
ASTROID	Anonymous System for Trading in Rupee OTC Interest Rate Derivatives
AUD	Australian Dollar
AUM	Assets Under Management
BIS	Bank for International Settlements
BISIP	BIS Investment Pools
BoP	Balance of Payment
bps	Basis Points
BRICS	Brazil, Russia, India, China and South Africa
BSA	Bilateral Swap Arrangement
BSL	Bilateral Swap Lines
CAC	Capital Account Convertibility
CAF	Common Application Form
CBDC	Central Bank Digital Currency
CBSL	Central Bank of Sri Lanka
CCIL	Clearing Corporation of India Limited
CIPS	Cross-Border Interbank Payment System
CKYCR	Centralised KYC Records Registry
CLS	Continuous Linked Settlement
CMIM	Chiang Mai Initiative Multilateralization
CNH	Chinese Yuan (Offshore)
CNY	Chinese Yuan (Onshore)
COFER	Currency Composition of Official Foreign Exchange Reserves
COMESA	Common Market for Eastern and Southern Africa
CPS	Centralised Payment Systems
CRR	Cash Reserve Ratio
DDP	Designated Depository Participants
DEIO	Department of External Investments and Operations
DEPR	Department of Economic Policy and Research
DFIA	Duty Free Import Authorisation
DGFT	Directorate General of Foreign Trade
DoR	Department of Regulation
DPSS	Department of Payment and Settlement Systems

ECB	External Commercial Borrowings
ECU	European Currency Unit
EME	Emerging Market Economies
EPCG	Export Promotion Capital Goods
FAR	Fully Accessible Route
FATF	Financial Action Task Force
FCA	Foreign Currency Asset
FCS-OIS	Foreign Currency Settled Overnight Indexed Swap
FCY	Foreign Currency
FDI	Foreign Direct Investment
FED	Foreign Exchange Department
FEMA	Foreign Exchange Management Act
FER	Foreign Exchange Reserves
FMI	Financial Market Infrastructure
FMOD	Financial Markets Operations Department
FMRD	Financial Markets Regulation Department
FPI	Foreign Portfolio Investor
FTP	Foreign Trade Policy
FTSE	Financial Times Stock Exchange
FVCI	Foreign Venture Capital Investors
FX	Foreign exchange
GC	Global Custodians
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GIFT CITY	Gujarat International Finance Tec-City
GNPA	Gross Non-Performing Asset
G-sec	Government Securities
HQLA	High-Quality Liquid Assets
IBU	IFSC Banking Units
ICS	Indian Clearing System
ICSD	International Central Securities Depositories
IDS	International Debt Securities
IES	Interest Equalisation Scheme
IGB	Indian Government Bonds
IMF	International Monetary Fund
India INX	India International Exchange (IFSC) Limited
INR	Indian Rupee
IRS	Interest Rate Swaps
IRTGS	International RTGS

KRW	South Korean Won
KYC	Know Your Customer
LAF	Liquidity Adjustment Facility
LCBSA	Local Currency Bilateral Swap Arrangement
LCR	Liquidity Coverage Ratio
LCS	Local Currency Settlement
LCY	Local Currencies
LEI	Legal Entity Identifier
LKR	Sri Lankan Rupee
LoC	Line of Credit
LRMF	Liquidity Risk Management Framework
LRS	Liberalised Remittance Scheme
MAI	Market Access Initiative Scheme
MAS	Monetary Authority of Singapore
MERCOSUR	Southern Common Market
MIBOR	Mumbai Interbank Offered Rate
MPD	Monetary Policy Department
MSCI	Morgan Stanley Capital International
MTF	Medium Term Framework
MTSS	Money Transfer Service Scheme
NBFC	Non-Banking Financial Companies
NDDC	Non-Deliverable Derivative Contracts
NDF	Non-Deliverable Forward
ND-OIS	Non-Deliverable Overnight Indexed Swaps
NDTL	Net Demand and Time Liabilities
NEFT	National Electronic Funds Transfer
NETS	Network for Electronic Transfers, Singapore
NIPL	NPCI International Payments Limited
NPCI	National Payments Corporation of India
NRE	Non-Resident External
NRI	Non-Resident Indian
NRO	Non-Resident Ordinary
NSE IFSC	NSE International Exchange
NSFR	Net Stable Funding Ratio
OCI	Overseas Citizen of India
OTC	Over The Counter
OVD	Officially Valid Documents
PBoC	People's Bank of China
PIO	Persons of Indian Origin

PMLA	Prevention of Money Laundering Act
PSL	Priority Sector Lending
PvP	Payment Vs Payment
RBI	Reserve Bank of India
RCEP	Regional Comprehensive Economic Partnership
RDB	Rupee Denominated Bonds
REPSS	Regional Payment and Settlement System
RMB	Chinese Yuan/Renminbi
RMBLA	Renminbi Liquidity Arrangement
RoDTEP	Remission of Duties or Taxes on Export Product
RTGS	Real Time Gross Settlement
SAARC	South Asian Association for Regional Cooperation
SDG	Sustainable Development Goals
SDL	State Development Loans
SDR	Special Drawing Rights
SEBI	Securities and Exchange Board of India
SEZ	Special Economic Zone
SFMS	Structured Financial Messaging System
SML	Sistema de Pagamentos em Moeda Local
SNRR	Special Non-Resident Rupee Account
SOFR	Secured Overnight Financing Rate
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TMA	Transport and Marketing Assistance
UBO	Ultimate Beneficial Owner
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UPI	Unified Payments Interface
USD	United States Dollar
VPA	Virtual Payment Address
VRR	Voluntary Retention Route

Terms of Reference

To examine issues related to internationalisation of INR and suggest a way forward, Shri T. Rabi Sankar, Deputy Governor, constituted an Inter-Departmental Group (IDG) in December 2021, chaired by Shri Radha Shyam Ratho, Executive Director.

The terms of reference of the IDG were as follows -

- To review the extant framework for use of INR for current and capital account transactions and assess their current levels;
- To review the extant position of use of INR for transactions between non-residents and the role of off-shore markets in this regard;
- To propose measures, consistent with the desirable degree of capital account liberalization, to generate incentives for use of INR for trade and financial transaction invoicing and denomination, official reserves and vehicle currency for foreign exchange intervention after analyzing data obtained from AD Banks on INR invoiced trading;
- To propose measures to bring greater stability in the exchange rate of INR determined by market forces and deep and liquid market with availability of wide range of hedging products, efficient banking system and world class infrastructure with easy accessibility to both residents and non-residents;
- To recommend measures to address concerns, if any, arising of the internationalisation of INR;
- Any other issue(s), the IDG considers relevant to the context.

Executive Summary

India's external sector has shown remarkable progress in the last three decades after the economic liberalisation reforms were set in motion. Over the years, linkages of the Indian economy with the rest of the world in terms of trade and capital flows have increased. In the last decade, India's foreign exchange reserves have grown from USD 290.5 billion in August 2012 to USD 560.4 billion in August 2022. During this decadal period, India's Foreign Direct Investment (FDI) has increased from USD 46.6 billion to USD 84.8 billion; imports have increased from USD 489.3 billion to USD 612.6 billion, and exports have grown from USD 306.0 billion to USD 421.9 billion. Meanwhile, the international monetary and financial system has moved towards being multipolar as reflected in the steadily decreasing share of USD in foreign exchange reserves of countries, the increasing usage of other currencies in trade invoicing and settlement, and the emergence of various bilateral and regional economic cooperation agreements. This, along with recent geopolitical developments, has set the stage for the emergence of various other currencies, including the INR, as prospective currencies for use in international transactions.

2. Against this backdrop and in accordance with the Terms of Reference, the Inter-Departmental Group (IDG) examined the prospects of internationalisation of INR and has recommended a roadmap to achieve the same. The IDG deliberated on all the issues related to internationalisation of INR in a granular manner and recommends a set of time bound steps, which would accelerate the pace of internationalisation. The IDG notes that some of these steps have already been initiated and are currently work in progress. The Group would also like to emphasize that the timeframe for the implementation of the various recommendations has been suggested keeping in view the institutional capacity, preparedness and priority of macro-economic supporting conditions.

3. The first chapter of the report discusses the concept of internationalisation of a currency. The IDG views internationalisation as a continuous process involving progressive capital account convertibility, wherein, the domestic currency increasingly acquires the character of a *de facto* freely convertible currency for international financial transactions. The size of an economy combined with the scale of external trade has a direct bearing on internationalisation of its currency. The IDG feels that INR has the potential to become an internationalised currency as India is one of the fastest growing countries and has shown remarkable resilience even in the face of major headwinds. Further, India has made appreciable progress in terms of capital account convertibility, global value chain integration, setting up of GIFT city, etc. The higher usage of INR in invoicing and settlement of international trade, as well as in capital account transactions, will give INR a progressively international presence. Various aspects related to the process as well as underlying factors impacting the pace of internationalisation of a currency have also been elucidated in this chapter.

4. The second chapter covers cross-country experience in internationalisation of currencies. The IDG reviewed the rise in prominence of the Chinese Yuan as an international currency (CNY as part of the IMF, SDR basket, composition of CNY in the foreign exchange reserves of various nations, etc.), in spite of China retaining capital controls in many areas. China's export-oriented manufacturing sector provides the basis for internationalisation of the Renminbi and this is supplemented by arrangements with partner countries in the

Disclaimer: ***This report and its recommendations reflect the views of the IDG and do not in any way reflect the official position of the Reserve Bank of India.***

form of bilateral currency swaps. Drawing on the Chinese experience, the IDG notes the important role that bilateral currency swaps can play in promoting use of INR for settling foreign trade thereby achieving internationalisation of INR. It is also observed that Local Currency Settlement (LCS) frameworks also facilitate wider use of local currencies in current and capital account transactions thereby facilitating the ease of doing business and reducing dependence on hard currencies.

5. The third chapter discusses the broad approach adopted by the IDG for internationalisation of the INR, which is to minimize negative disruptions and envisages continuous change in the architecture of Indian financial system by generating natural stimulants for spurring international demand of INR for cross border transactions. The current level of Capital Account Convertibility (CAC) gives enough room for initiating steps towards internationalisation. The recent initiative taken under the Asian Clearing Union arrangement to introduce INR as a settlement currency is also a timely step to encourage use of INR for multilateral settlement of international trade transactions. While we have had INR arrangements with Bhutan and Nepal for a long time, the recent decision by Sri Lanka to formally include INR as a designated foreign currency augurs well for incremental internationalisation of INR. Overall, the IDG's approach was to identify the existing level of internationalisation of INR and suggest a roadmap towards internationalisation at a steady pace. The IDG notes that several measures have been taken to increase non-residents' participation in the domestic economy, integrate onshore and offshore financial markets and foster greater Indian participation in global trade and finance, and feels that it is essential to continue on this path. Further, robust financial markets would facilitate successful internationalisation of INR. This would also require use of macro-economic prudential tools as a part of a well-defined risk management framework. The IDG opines that CAC is not a pre-condition for internationalisation of INR, or vice-versa.

6. The internationalisation of a currency is also closely interlinked with the nation's economic progress especially its prominence in global trade. The measures for promoting internationalisation of INR would involve steps towards parallelly liberalising the capital account, promoting international usage of INR, and strengthening financial markets. The fourth chapter discusses all these issues in detail. The IDG is of the view that internationalisation is a process rather than an event, with continuous efforts to build upon all the initiatives that have been taken in the past.

7. The IDG's recommendations are covered in chapter five of the report. The recommendations have been divided as per the expected time required for implementation. The timeframe of these recommendations has been determined based on the institutional capacity, macroeconomic priority and suitability of accompanying pre-requisites.

8. Over the short term, the IDG recommends the following:

- Designing a template and adopting a standardised approach for examining the proposals on bilateral and multilateral trade arrangements for invoicing, settlement and payment in INR and local currencies.
- Making efforts to enable INR as an additional settlement currency in existing multilateral mechanisms such as ACU.
- Facilitating LCS framework for bilateral transactions in local currencies and operationalising bilateral swap arrangements with the counterpart countries in local currencies.

- Encouraging opening of INR accounts for non-residents (other than nostro accounts of overseas banks) both in India and outside India.
- Integrating Indian payment systems with other countries for cross-border transactions.
- Strengthening financial markets by fostering a global 24x5 INR market and promoting India as the hub for INR transactions and price discovery.
- Facilitating launch of BIS Investment Pools (BISIP) in INR and inclusion of G-Secs in global bond indices.
- Recalibrating the FPI regime and rationalizing/harmonizing the extant Know Your Customer (KYC) guidelines.
- Providing equitable incentives to exporters for INR trade settlement.

9. Over the medium-term horizon, the IDG has recommended:

- A review of taxes on Masala bonds.
- International use of Real Time Gross Settlement (RTGS) for cross border trade transactions and inclusion of INR as a direct settlement currency in the Continuous Linked Settlement (CLS) system.
- Examination of taxation issues in financial markets to harmonise tax regimes of India and other financial centres.
- Allowing banking services in INR outside India through off-shore branches of Indian banks.

10. Finally, the IDG feels that over the long term, India will achieve higher level of trade linkages with other countries and improved macro-economic parameters, and INR may ascend to a level where it would be widely used and preferred by other economies as a “vehicle currency”. Thus, the IDG recommends that in the long run, efforts should be made for inclusion of INR in IMF’s SDR basket.

1 Introduction

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.

- S. S. Tarapore Committee on Fuller Capital Account Convertibility, 2006

Looking ahead, the emergence of INR as an international currency appears inevitable. While greater internationalisation of the INR can lower transaction costs of cross-border trade and investment operations by mitigating exchange rate risk, it can also complicate the conduct of monetary policy. Internationalisation of a currency makes the simultaneous pursuit of exchange rate stability and a domestically oriented monetary policy more challenging unless supported by large and deep domestic financial markets that could effectively absorb external shocks.

- Report on Currency and Finance, 2020-21, RBI

This chapter provides an overview of the accepted definition of internationalisation of a currency and examines the need and enabling factors required for internationalisation of the INR. We review the available research in this context and explain why further internationalisation of the INR makes economic sense.

An international currency is used and held beyond the borders of the issuing country for transactions between residents and non-residents, and between residents of two countries other than the issuing country.Currency internationalisation[1] has thus been described as the international extension of a national currency's basic functions of serving as a unit of account, medium of exchange and store of value. In other words, the internationalization of a currency is an expression of its external credibility as the economy integrates globally[2]. The US dollar is said to enjoy an 'Exorbitant Privilege'[3] among global currencies[4]. American economist, Barry

[1] Zhang, Zhiwen, Makin, Anthony J, and Qinxian Bai (2016). "Yen internationalization and Japan's international reserves", Economic Modelling, Elsevier.

[2] RBI (2006). "Report of the Committee on Fuller Capital Account Convertibility", RBI Report, July 2006.

[3] Exorbitant Privilege, in general, 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.

[4] The term was first used by Valéry Giscard d'Estaing, the French Minister of Finance, in the 1960s.

Eichengreen (2001)[5], explains that "It costs only a few cents for the Bureau of Engraving and Printing to produce a USD 100 bill, but other countries had to pony up USD 100 of actual goods in order to obtain one." The US dollar has been the dominant global currency for the better part of the last century. Its 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; the incomplete nature of the European monetary union; a shrinking population and uncertain debt dynamics in Japan; and the relative decline of the UK economy. These have undermined the Euro, the Japanese Yen, and the British Pound, as viable challengers to the US dollar. Other attractive stores of value — the Swiss franc, the Canadian dollar, and the Australian dollar — lack the scale to become a dominant global currency. The obvious challenger to the US dollar dominance is the Chinese Renminbi, but 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. 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 internationalpayment mechanisms based on the Society for Worldwide Interbank Financial Telecommunications (SWIFT) messaging system (which are effectively and predominantly controlled by advanced western economies). An alternative currency system may also emerge where the currency of denomination will be local as opposed to the global ones such as the US dollar and the Euro.

The international standing of currencies forms a principal characteristic of the international monetary order, shaping the world's economic and financial systems. Internationalisation of any currency, with its embedded costs and benefits, tends to be a very slow-moving process, characterised by considerable inertia. The realisation of these costs and benefits will in turn depend on several factors and preconditions as elaborated in this chapter.

1.1 What is an International Currency?

Conceptualising international currencies based on their monetary functions is the most widely used way of defining them. This method was proposed by Cohen (1971)[6] in his writing in the early 1970s about the British Pound sterling and subsequently refined by Kenen (1983)[7], Krugman (1984)[8], and others. Just like a domestic currency, an international currency performs the three functions of money – as a medium of exchange, a unit of account, and a store of value. It does so at two distinct levels, for private and public transactions and resultantly plays six roles in total (Table 1.1). As a medium of exchange, it is used by private actors to settle international

[5] Eichengreen, Barry (2011). "Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System", Oxford: Oxford University.

[6] Cohen, Benjamin J. (1971). "The Future of Sterling as an International Currency".

[7] Kenen, Peter B. (1983). "The Role of the Dollar as an International Currency", Occasional Paper No. 13, New York: Group of Thirty.

[8] Krugman, Paul. (1984). "The International Role of the Dollar: Theory and Prospect", In Exchange Rate Theory and Practice, edited by John Bilson and Richard Marston. Chicago, IL: University of Chicago Press.

Table 1.1: The Roles of an International Currency

Function	Sector	
	Private	Official
Unit of Account	Currency is used to invoice foreign trade and denominate international financial instruments.	Currency is used in expressing exchange rate relationships.
Medium of Exchange	Currency is used to settle international trade and to discharge international financial obligations.	Intervention currency in the foreign exchange markets and currency used for the balance of payments financing.
Store of value	Currency is used to denominate deposits, loans and bonds.	Reserve assets held by monetary authorities.

economic transactions or by governments as a vehicle for exchange market intervention and balance of payments (BoP) financing. As a store of value, it acts as a reserve currency and at a private level, it is held as capital assets.

1.2 Is internationalisation of a currency desirable? The benefits of currency internationalisation

The benefits of currency internationalisation accrue largely to a country's private sector and are fairly evident. These may be larger for a relatively small economy than for a large one. Firstly, the internationalisation of its currency allows the country's exporters and importers to limit exchange rate risk. As the internationalisation of a country's currency broadens and deepens its financial market, domestic firms may be able to invoice and settle their exports/imports in their currency, thus shifting exchange rate risk to their foreign counterparts. Secondly, it permits domestic firms and financial institutions to access international financial markets without assuming exchange rate risk. Thirdly, the internationalisation of its currency offers new profit opportunities to financial institutions, although this benefit may be offset in part by the entry of foreign financial institutions into the domestic financial market (to the extent that the government permits it). Finally, a larger, more efficient financial sector may serve the domestic non-financial sector better by reducing the cost of capital and widening the set of financial institutions that are willing and able to provide capital. This would boost capital formationin the economy thereby increasing growth and reducing unemployment.

Currency internationalisation may, of course, allow a country's government to finance part of its budget deficit by issuing domestic currency debt in international markets rather than issuing foreign currency instruments. It may, likewise, allow a government to finance part, if not all, of its current account deficit without drawing down its official reserves. This benefit is not confined exclusively to reserve currency countries such as the United States, whose government debt is one of the principal reserve assets held by foreign central banks and governments. The current account deficit may also be financed by private capital flows from abroad, especially from the banking system, as financing in domestic currency becomes integrated globally. Further, the internationalisation of a currency reduces the requirement for the authorities to maintain and depend on large foreign exchange reserves in convertible currencies (along with its associated costs) to manage external vulnerabilities. Further, at the macroeconomic level, internationalisation of a currency results in lowering the impact of sudden stops and reversals of capital flows and enhances the ability to repay external sovereign debt.

1.3 Costs of Internationalisation

However, there are certain challenges to the internationalisation of a currency as it may result in the potential increase in volatility of its exchange rate in the initial stages. This would further have monetary policy implications as the obligation of a country to supply its currency to meet the global demand may come in conflict with its domestic monetary policies, popularly known as the Triffin dilemma. Also, the internationalisation of a currency may accentuate an external shock, given the open channel of the flow of funds into and out of the country and from one currency to another.

The costs also emanate from the additional demand for money and also an increase in the volatility of the demand. With the advances in statistical reporting, most central banks can separate foreign demand for money, but with regard to some components, such as cash, uncertainty remains. International currency use can also have an impact on financing conditions in a way that is, at times, undesired. During his last years in office, former Federal Reserve Chairman Alan Greenspan said it was a 'conundrum' that long-term interest rates were so low and that the Fed 'failed' to get long-term rates to rise sufficiently, largely due to foreign demand for long- term bonds. To summarise, the main costs of allowing greater international use of the currency emerge from the possible increased volatility in the exchange and money markets, thus making the conduct of monetary policymore complex.

Overall, however, the benefits of internationalisation in terms of limited exchange rate risk, lower cost of capital due to better access to international financial markets, high seigniorage benefits and reduced requirement of foreign exchange reserves far outweigh the above concerns. Further, as the internationalisation of a currency is a long-drawn process involving continuous change and incremental progress, it would enable timely redressal of the associated concerns and challenges as we move forward.

1.4 Process of internationalising a Currency

No single factor determines the successful internationalisation of a currency. Widespread use of a currency outside the issuer's borders could be due to a combination of factors, such as the size of the economy and centrality to global trade. Factors like capital account openness, macroeconomic stability and depth of financial markets, which provide global investors with a safe store of value, also influence the extent of a currency's usage outside national borders. Kenen (2009)[9] enumerates the possible roadmap for internationalisation as under:

i. Removal of all restrictions on any entity, domestic or foreign, to buy or sell the country's currency, whether in the spot or forward market.

ii. Domestic firms can invoice some, if not all, of their exports in their country's currency, and foreign firms are likewise able to invoice their exports in that country's currency, whether to the country itself or to third countries.

iii. Foreign firms, financial institutions, official institutions and individuals can hold the country's currency and financial instruments/assets denominated in it, in amounts that they deem useful and prudent.

iv. Not only are foreign firms and financial institutions able to issue marketable instruments in the local currency, but the issuing country's resident entities are also able to issue local currency-denominated instruments in foreign markets.

v. International financial institutions, such as the World Bank and regional development banks, can issue debt instruments in a country's market and use its currency in their financial operations.

[9] Kenen, Peter B. (2009). "Currency Internationalization: An Overview", BIS Research Paper, Bank for International Settlements, Basel.

1.5 Factors impacting the pace of internationalisation of a currency

The economic size of a country plays the most vital role in determining the pace of internationalisation. Besides this, the demand-side factors like network effects, invoicing practices and store of value and the supply-side factors such as domestic financial market depth, offshore markets, currency convertibility and capital account liberalisation, together with financial openness also play an important role in influencing the international acceptance of the currency. Mohan, Patra and Kapur (2013)[10] have identified four prerequisites for internationalisation.

- The reserve currency country should have deep and liquid financial and foreign exchange markets, which would facilitate the conduct of foreign exchange policies, manage currency risks effectively and support financial asset transactions denominated in the reserve currency.
- Currency convertibility and a credible commitment to an open capital account to facilitate financial flows with minimal transactions costs; liquidity (narrow bid-offer spreads in normal and stress times); a full yield curve (to be able to manage duration and curve positioning); and depth, offering a range of products across different credit qualities (to achieve the desired level of credit risk).
- Wide use in private sector transactions: a currency with a large share in world gross domestic product (GDP), trade and finance attracts more users and establishes network externalities. For example, if the country issuing the reserve currency is also a large exporter or importer, it could have the bargaining power to impose the use of its currency and increase acceptance of its currency. Further, such a financially integrated economy typically enhances the breadth and depth of its domestic financial markets.
- Macroeconomic and political stability: Policymaking institutions with credibility and a track record of maintaining price stability are critical ingredients to sustaining confidence in the currency's long-term purchasing power.

Internationalisation gathers pace as a country progresses on the path of fulfilling the above pre-conditions. It is evident from the literature that while internationalisation is a desirable goal for an aspirational economy, it is a decision with several moving parts/imponderables and therefore needs a holistic examination. The Inter-Departmental Group (IDG) has thus started from this premise and attempted an in-depth analysis of all the relevant issues relating to internationalisation of INR.

1.6 Trends in the use of international currencies

The international monetary system has been evolving over the last few decades in response to major structural shifts in the global economy. The dollar's reserve currency status has been supported by the sustained leading position of the US in the world order, the use of the US dollar for trade invoicing and cross-border investments across the world, and the preferred choice of currency as an exchange rate anchor. However, there has been a definitive downward trend in the share of the US dollar as part of global foreign exchange reserves, which has declined from about 85 per cent in the 1970s to around 70 per cent in the early 2000s and further down to

[10] Mohan, Rakesh, Patra, Michael Debabrata and Muneesh Kapur (2013). "Currency Internationalization and Reforms in the Architecture of the International Monetary System: Managing the Impossible Trinity", The Brazil, Russia, India, China and South Africa (BRICS) and Asia, Currency Internationalization and International Monetary Reform, Paper No. 5.

58.9 percent in the first quarter of 2022[11]. However, the share of the US dollar continues to be high, especially considering the decline of GDP of USA as a percentage of world GDP from around 40 per cent to 24 per cent over the same period.

This declining trend is not just a result of diversification away from the US dollar by most reserve managers, especially towards currencies of China and other smaller open market economies, such as Australia, Canada, and South Korea. The trend also reflects an attempt by some emerging and developing Asian economies to internationalise their currencies to complement their share in global trade and output. Globalisation and the consequent dispersion of global output and power away from the western world have led to a more multipolar global economy.

The recent geopolitical developments, especially the Ukraine conflict, that started in February 2022 and the freezing of almost half of Russia's foreign exchange reserves by western countries and the suspension of its banks from participation in the SWIFT messaging system will likely accelerate this diversification and may lead to an even more multipolar international monetary system. Given the size of the Chinese economy and the degree of its integration with global trade and finance, China has emerged as a natural competitor for the US and the Renminbi holds the potential to gain a bigger share of international foreign exchange reserves globally. It may, however, be a slow process as the Renminbi is not fully convertible on the capital account, and the Chinese financial markets are under-developed and less transparent relative to the US.

1.7 Can the Rupee become an international currency?

During the last two decades, India has emerged as one of the world's fastest growing economies and also a preferred destination for global investors. The Indian economy has also shown remarkable resilience against adverse global developments, especially during the COVID-19 pandemic. Given the potential benefits of internationalisation of INR in terms of lower transaction costs for cross-border trade and investment operations and lower exchange rate risk, various measures have been taken towards this end over the years, including the calibrated easing of regulations to promote greater convertibility on the capital account. Furthering internationalisation and capital account convertibility (CAC) would, however, require the complementary efforts of multiple stakeholders, including regulators, policymakers and industries. As Governor of RBI, Shaktikanta Das[12], observed, "Capital account convertibility will continue to be approached as a process rather than an event, taking cognizance of prevalent macroeconomic conditions."

For promoting internationalisation, India needs to encourage trade invoicing in INR, as is already permitted. From a purely strategic point of view, it makes sense to settle bilateral trades in INR. This can be done initially with regional partners. Further, invoicing and settling of international trade transactions in INR with trade partners with whom we have a trade deficit (say, the oil exporting countries) will in general lead to a reduction in the current account deficit denominated in convertible currencies. Commensurately, there will be a reduced need to maintain large foreign exchange reserves in convertible currencies.

[11] IMF (2022). Currency Composition of Official Foreign Exchange Reserves data, IMF, June 2022, available at https://data.imf.org/COFER

[12] Das, Shaktikanta (2020). "Accelerating Financial Market Reforms in India", Speech at 4th Annual Day of FEDAI, November 26, 2020.

There is some anecdotal evidence that INR is accepted to some extent in Singapore, Malaysia, Indonesia, Hong Kong, Sri Lanka, United Arab Emirates (UAE), Kuwait, Oman, Qatar and the United Kingdom (UK), among others, while it is legal tender in Nepal and Bhutan. The Nepal Rastra Bank, Royal Monetary Authority of Bhutan and Bank Negara Malaysia also hold Government of India securities and Treasury Bills. Some sovereigns, like Singapore, hold Indian equity and bond assets (including G-secs) through their sovereign wealth funds.

Various measures have been undertaken in recent times to promote the internationalisation of INR. These, *inter alia*, include:

(i) allowing issuance of offshore Rupee-denominated 'masala' bonds;

(ii) allowing domestic banks to freely offer foreign exchange prices to non-residents at all times, out of their Indian books, either by a domestic sales team or through their overseas branches;

(iii) allowing Rupee derivatives (with settlement in foreign currency) to be traded in International Financial Services Centers (IFSCs); and

(iv) an additional arrangement for invoicing, payment and settlement of export/import in INR has been enabled vide circular dated July 11, 2022.

According to an IMF Staff Discussion Note on 'Internationalisation of Emerging Market Currencies: A Balance between Risks and Rewards' (October 2011), the Indian Rupee, the Brazilian Real, the Chinese Renminbi, the Russian Ruble and the South African Rand were identified as the key emerging market currencies with the potential for internationalisation. According to the IMF note, all these economies have significant regional importance and economic weight, and despite severe data limitations, there is evidence that the use of these emerging market currencies in international transactions has shown a marked increase in the past few years. These developments have challenged the orthodoxy and have shown that full capital account convertibility may not be a necessary prerequisite for internationalisation.

Looking ahead, the conditions seem opportune for the emergence of INR as an international currency. It is possible that greater cross-border flows could cause greater variability in domestic macro parameters. It is argued that the bilateral currency swap arrangements may provide a blueprint for reducing the dependence on the US dollar for settling trade transactions. Interestingly, China has followed a similar approach by using a large number of bilateral swaps and Lines of Credit (LoC) to encourage the use of the Renminbi for international trade transactions. Trade transactions between countries, where there is an underlying swap at the central bank level to take care of liquidity mismatches, would benefit from greater exchange rate stability. This would further propel international trade volumes through higher stakeholder confidence for invoicing and settlement in domestic currencies. However, the way forward for further internationalisation of the INR would involve a series of coordinated public policy steps. Thus, a template or standardised approach must be prepared to engage with the interested central banks for local currency settlement/swaps/LoC. This may emerge as the inflexion point for the process of further internationalisation of INR.

This IDG has deliberated on all the above key issues and suggested suitable reform measures and recommendations in this regard.

2 International experiences and their relevance forinternationalisation of the Indian Rupee

Cross-country studies provide learning opportunities and illustrate the path followed by countries in their endeavour to internationalise their currencies. While the Chinese Renminbi provides the most comprehensive example of multi-pronged efforts at internationalisation of their currency spanning the last few decades, the IDG also studied regional currency arrangements in South America and Africa. These represent significant efforts to reduce the use of convertible currencies, especially in the trade of goods and services. Specific issues examined by the IDG include Local Currency Settlement mechanisms; bilateral currency swap arrangements; development of an ecosystem in financial markets for domestic currencies, including hedging and availability of direct quotes; studying Government incentives for trade invoiced in domestic currencies, and expanding the scope of special non-resident accounts in domestic currency.

The evolution of international currency systems has been the topic of academic discussion. While it is generally accepted that the predominance of a single currency like the Pound Sterling in the colonial pre-war world or the emergence of the US dollar as the single largest denominator for international transactions was more a result of economic power intertwined with political dominance, there have been other instances where nations have tried to improve the international acceptance of their currency. Over the last twenty years, we have witnessed the adoption of a single currency across Europe in the late 1990s known as the Euro, which first appeared as the European Currency Unit (ECU) in 1979. In this century, there has been a considerable focus of economic literature on the attempts of the Chinese authorities to internationalise the Renminbi with mixed results.

In this chapter, some of the international experiences that the IDG reviewed are covered. The key learnings/ takeaways from these experiences are also explored.

2.1 Growth of the US dollar as an international currency and current issues

The rise of the US dollar to the current position of dominance can be traced back to the failure of the Bretton Woods system to give rise to what was called the Jamaica System[13]. The Jamaica System was not so much an international monetary framework as it was an '*ad hoc* non-system'[14]. It was rather an affirmation of the prevailing international monetary system. This system had the following basic characteristics: First, it had, as international reserve currencies, several freely convertible currencies of developed countries, the most important of which was the US dollar. Second, the international reserve currencies were backed up by the credit of the issuing countries without any connection to gold. Third, the exchange rates between the currencies floated freely according to the changes in their demand and supply in the foreign exchange market.[15]

In the current international monetary system, the US dollar is the most important international reserve currency. The United States has obtained great economic benefits from the dollar being the predominant international reserve currency, the most important of which, arguably, is international seigniorage income. The dollar reserves or savings held by countries all over the world are acquired by exporting goods or selling assets, which means the United States can get these goods only with the cost of interest. Of course, the dollar reserves or savings held by

[13] The Jamaica System is named after the Accord that was ratified in 1976 by IMF members at Kingston, Jamaica.

[14] Ocampo, José Antonio (2017). "Resetting the International Monetary (Non)System", Oxford, Oxford Academic.

[15] Li, Chong (2022). "To Establish a Supra-sovereign International Currency – The Reform of International Monetary System", Beijing Normal University Press, Springer Singapore.

other countries can also form the purchasing power of American goods or assets, but as long as other countries hold dollars in the form of dollar reserves or savings, the United States can continue to gain wealth.

However, there is an inherent defect in this system. When the economy of the issuing country of the international reserve currency is strong, it obtains the international seigniorage income by virtue of monetary privilege, resulting in unfair distribution of benefits. But when the economy of the issuing country of the international reserve currency becomes weak, it leads to disorder in the international monetary order, and eventually, the loss percolates to the holders of the international reserve currency instead of the loss accruing to the issuing country.

To maintain the normal operation of the Jamaica System, the United States needs to maintain corresponding obligations and responsibilities while receiving huge rights and interests. However, when facing a conflict between its interests and the interests of the rest of the world, the US government has in the past not hesitated to protect its interests, which furthers the imbalance in the international monetary system.

It, therefore, seems evident, that while the US dollar's 50-year long dominance remains unchallenged for now, it has started to erode slowly, and the economic order will have to evolve to look beyond the US dollar in the future.

2.2 The Euro Experience

The advent of the Euro was widely anticipated even outside the Euro area as it was (and still is to some extent) considered to be the alternative to the US dollar. The Euro is not only an international currency beyond national sovereignty, but also performs all functions of a national currency. Since its birth, the Euro has functioned as the unit of valuation, medium of exchange, means of payment and reserve currency worldwide due to the economic status of the countries it represents.

The Euro has, however, not been able to live up to the entire promise, mainly due to two reasons. Firstly, although the currency union and unified monetary policy have existed for over twenty years, the independent fiscal policies along with regional disparities have remained wide. The inclusion of the smaller countries into the European Union and events such as Brexit have only exacerbated this divide. Secondly, and more importantly, for other countries/currencies, the Ukraine conflict and the coordinated approach adopted by the authorities in USA and Europe in terms of economic sanctions have raised concerns about the utility of Euro as an alternative to the US dollar.

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 IDG, therefore, feels that it is imperative for India to continue exploring alternatives to both the USD and the Euro.

2.3 Experience of the Australian Dollar (AUD)

The transition of AUD from an insular currency to an internationalised currency took over a decade, starting in 1983 when the currency was made a free float and capital controls were dismantled. The transition was facilitated by the development of an active local bond market and a non-deliverable forward currency market. The floating exchange rate acted as a buffer to external shocks, particularly to shifts in terms of trade. It allowed the economy to absorb these shocks without the associated large inflationary or deflationary pressures that tended to follow, under the previous fixed or managed exchange rate regimes[16].

[16] Battellino, Ric and Michael Plumb (2009). "A generation of an internationalised Australian dollar", BIS Paper no. 61.

AUD in the global bond market – An internationalised currency serves non-residents as a store of value whenever they buy or sell deposits or bonds denominated in the currency. For AUD, this went beyond non-resident investment in the domestic bond market. Non-resident investors have the convenience of Australian issuers selling AUD bonds offshore. Large sums have been raised by non-resident borrowers issuing AUD bonds in the domestic market (kangaroo bonds) and by non-resident issuers of AUD bonds marketed to offshore investors. The development of a derivatives market and, in particular, a currency swap market played an important role in the internationalisation of the AUD bond market. Well developed interest rate swap and currency markets linked the domestic and international markets. Further, despite a withholding tax on coupons paid on domestic bonds, a broad tax exemption applicable to offshore issues gave the latter an extra source of support and may have even encouraged resident issuers to issue offshore[17].

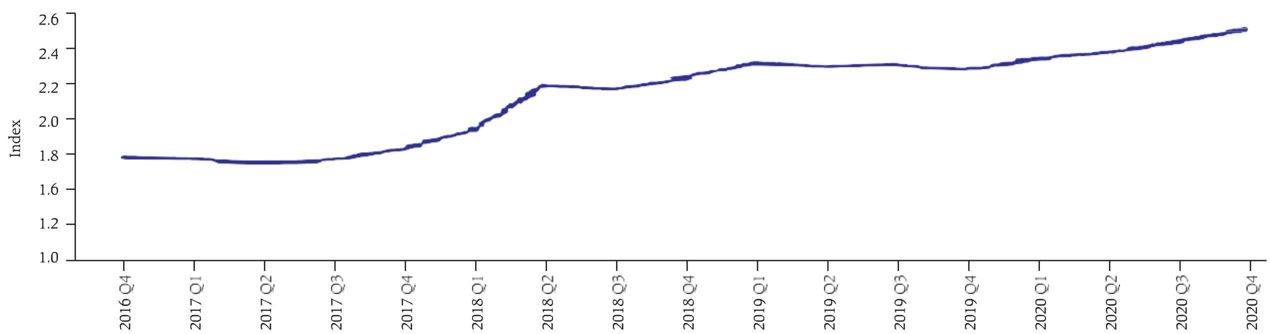
Australia has substantial net foreign liabilities that are denominated in domestic currency. Banks in Australia play a prominent role as they can, on account of their strong credit rating, borrow from foreigners on attractive terms and act as an intermediary between the domestic economy and international investors.

The Australian example shows that a currency can make the transition from extensive controls designed to restrict its use to domestic residents to the status of an internationalised currency within a few years. The process was facilitated by the removal of various restrictions and by the development of a vibrant domestic fixed income market on which a range of derivatives were based. AUD's internationalisation in the backdrop of the assets' yield advantage over US dollar assets, demonstrates that currencies with higher interest rates might internationalise faster than currencies with relatively lower interest rates.

2.4 Internationalisation of Chinese Renminbi (RMB)

China is by far the second largest economy in the world and is rapidly catching up with the United States. In a bid to reduce dependence on the US dollar and assert its influence on international trade and finance, China has been continuously making efforts to increase the international use of its currency. Hu and Chen (2013) developed an index called the RMB Internationalisation Index, which is now widely used to assess the internationalisation of the Renminbi (Chart 2.1).[18]

Chart 2.1: RMB Internationalisation Index

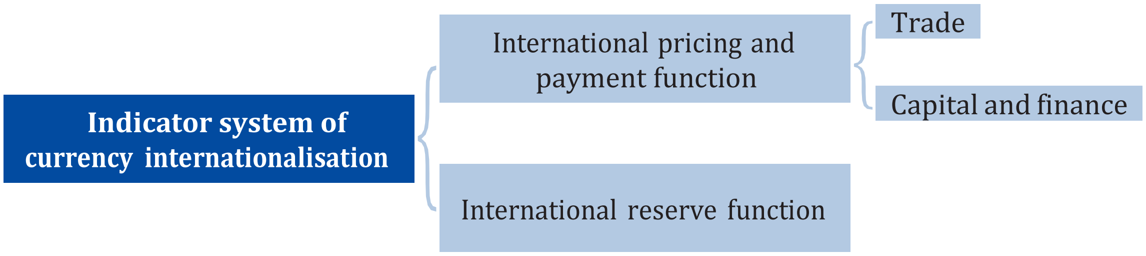


Source: Review of the method of valuation of the SDR, IMF (2022)

[17] McCauley, Robert N. (2006). "Internationalising a Currency: The Case of the Australian Dollar", BIS Quarterly Review, December 2006.

[18] Chen, Y., and B. Hu. (2013). "Internationalization of the RMB: An Evaluation Framework", Economic and Political Studies 1(1): 5–20.

The index is developed on the following schema and the index levels are periodically published.



The focused effort of the Chinese authorities in the internationalisation of their currency merits full evaluation. In 2003, China stepped up its efforts towards promoting the internationalisation of the Renminbi by (i) allowing border trade to be denominated and settled in Renminbi, (ii) permitting foreign trade institutions to open settlement accounts in banks in China's border areas for collections and payments in border trade, and (iii) encouraging banks in China's border areas to establish corresponding banking relationships with banks in neighbouring countries' border areas to settle border trade through banks **(Annex 2.1).**

Subsequently, some of the events that have supported the internationalisation efforts taken by China are:

- Seeking to reduce the reliance of importers and exporters on the US dollar, trial use of Renminbi-denominated settlement of trade between five cities (Shanghai, Guandong, Shenzen, Zhuhai and Dongguan - major special economic zones, SEZs) and Hong Kong, Macau and Association of Southeast Asian Nations (ASEAN) countries was started in 2009. This was augmented by tax breaks for companies and People's Bank of China (PBoC) encouraged banks to offer Renminbi settlement services.[19]
- Chiang Mai Initiative Multilateralisation (CMIM) is the regional currency swap agreement between the ASEAN countries and China, Japan and South Korea (ASEAN+3). It was established in 2010 with a total of USD 120 billion in swap lines and expanded in 2014 to USD 240 billion, of which China contributes about USD 77 billion (USD 68 billion, excluding its swap line with Hong Kong). Initially, participating central banks, including the PBoC, agreed to provide US dollars to their CMIM partners in exchange for local currencies. In March 2021, it was then agreed to permit local currency swaps on a voluntary and demand-driven basis. It serves as a channel for Renminbi liquidity for partner countries.
- The PBoC has bilateral currency exchange agreements with 39 central banks, totalling RMB 3.7 trillion (USD 550 billion). In contrast to Federal Reserve swap lines, however, these are not permanent and unlimited in amount. In each case, the maximum amount that can be borrowed is specified by an agreement with the foreign central bank. Till date, there is only limited evidence of the actual use of Renminbi swap lines.
- In October 2015, China launched its Cross-border Interbank Payment System (CIPS). CIPS is a messaging and clearing system for international transactions. It allows international banks to clear cross-border RMB transactions with their onshore Chinese counterparts directly, rather than through clearing banks located in offshore centres, which in turn have correspondent relationships with Chinese banks.

[19] Sekine, Eiichi. (2010). "Yuan-Denominated Trade Settlement and the Internationalization of China's Currency", Nomura Journal of Capital Markets, Vol. 2, No. 1, 2010.

- In 2017, the launch of the Bond Connect program opened an additional channel through which international investors could access the Chinese market with enhanced operational efficiency, especially regarding account opening and trade settlement. These efforts led Chinese stocks and bonds to be added to benchmark indices, such as Morgan Stanley Capital International (MSCI), Financial Times Stock Exchange (FTSE) Russell World Government Bond Index, Bloomberg Barclays Global Aggregate Index and JP Morgan Government bond index-Emerging markets.
- The first multilateral free trade agreement through Regional Comprehensive Economic Partnership (RCEP), recently ratified in January 2022, forms a new trading bloc comprising of China and fourteen nations, which include the ASEAN countries, as well as Japan, Australia, and New Zealand. China is one of the nations that will benefit the most from the RCEP because there will be increased access to their goods across the region, giving them a chance to gain more investment support. China is already the largest trading partner of ASEAN, and this agreement can further strengthen its position.
- Digital Yuan – China is one of the leaders in Central Bank Digital Currency (CBDC) research and execution. The digital Yuan may not be an international currency yet, but it is certainly gaining momentum in China. Domestic usage of the digital Yuan could have a spillover effect on several international currencies as China is the second largest economy in the world and also has the world's largest share in global trade. The digital Yuan will allow China to issue more debt in the Renminbi and strengthen networks and mechanisms for debt repayment.
- In May 2022, the International Monetary Fund, in the latest valuation review of the Special Drawing Right (SDR) raised Renminbi's weight in the basket of currencies that make up the SDR by 1.36 percentage points to 12.28 per cent. With this, the Renminbi now accounts for the third-largest share in the SDR basket.
- In June 2022, the Bank for International Settlements (BIS) announced a Renminbi Liquidity Arrangement (RMBLA) developed with the PBoC to provide liquidity to central banks through a new reserve pooling scheme. The reserve pooling provides additional features as participating central banks would not only be able to draw down on their contributions but would also gain access to additional funding through a collateralised liquidity window operated by BIS, up to an amount equivalent to the central bank's share of the collateralised liquidity window. This signals to the world that Renminbi can also play a global role for liquidity purposes.

Although China has made considerable efforts to expand the use of the Renminbi in recent years, a less transparent and underdeveloped financial system, continued capital control measures, and limitations on Renminbi convertibility hinder further internationalisation of its currency. The share of the Renminbi in global reserve portfolios, at 2 per cent, pales in comparison with those of the US dollar and the Euro. As a country with a less open system and lacking transparent policies, it remains to be seen how far China can inspire the confidence of the global community in the Renminbi.

Eichengreen, *et al.* (2022)[20] argue that China can adopt its model of the Renminbi as long as certain economic fundamentals are met. The economic prerequisites include the backing of the currency by foreign exchange reserves, liquidity support through central bank swaps and calibrated access for foreigners to onshore investment opportunities.

[20] Eichengreen, Barry; Macaire, Camille; Mehl, Arnaud *et al.* (2022). "Is Capital Account Convertibility Required for the Renminbi to Acquire Reserve Currency Status?", CEPR DP 17498, July 2022.

Some of the key takeaways for the IDG from the experience of Renminbi internationalisation are listed below:

(i) Full capital account convertibility seems to be a desirable but not necessary pre-condition to the internationalisation of a currency. However, the central bank needs to be ready to provide liquidity (for example through bilateral swap arrangements) and allow conversion into other currencies.

(ii) The Chinese authorities have leveraged Hong Kong to increase the internationalisation of their currency. While this move has improved liquidity, particularly in channelising investments, the CNH-CNY currency (and therefore exchange rate) system does not seem to be adding any significant value.

(iii) There seems to be considerable merit in expanding the use of local currencies, particularly with the largest trading partners. Settlement of trade in local currencies can also be incentivised through fiscal measures, trade policy and enabling financial market infrastructure.

(iv) The Chinese authorities have adopted a process of slow liberalisation of capital account and financial markets.

2.5 Regional Settlement Mechanisms

2.5.1 South America SML: Sistema de Pagamentos em Moeda Local (Local Currency Payment System)

SML is an international payment system that settles bilateral financial transactions in local currencies within the Southern Common Market (MERCOSUR) countries, *i.e.*, Brazil, Argentina, Uruguay and Paraguay. It is a payment system, which allows end users to receive and pay in their currencies. Both legal entities and individuals can conduct transactions through SML. The sender (importer) registers his/her transaction and makes the payment in his/her currency through an authorised financial institution. Thereafter, bilateral netting is conducted between the concerning central banks, who act only as intermediaries. The daily balance is settled in US dollars withintwo days and is calculated based on the SML rates used in the transactions. The SML rate is published daily after markets' closure in both countries. The SML rate is the ratio between the official exchange rates of local currencies against the US dollar. The exporting country's central bank then makes the amount available to its authorised financial institution in local currency where the exporter has his account. The SML operational flow has been illustrated in **Annex 2.2**.

The IDG felt that the mechanism would enable the settlement of bilateral trade in domestic currencies of importer and exporter. The system, therefore, has attempted to resolve the issue of bilateral exchange rates in the absence of a market quotation, even though the daily net settlement is done in a convertible currency.

2.5.2 Eastern and Southern Africa- COMESA REPSS

The Common Market for Eastern and Southern Africa (COMESA) has developed Regional Payment and Settlement System (REPSS), a regional payment and settlement initiative. The operator and administrator of the REPSS is the COMESA Clearing House. The Central Bank of Mauritius acts as the Settlement Bank, where final funds settlement of net positions is performed at end of the day. Any payment made between participating countries is cleared daily, on a net basis. Thus, REPSS is a Multilateral Netting System with End-of-Day Settlement in a single currency (USD or Euro), with the system allowing for settlement in a multicurrency environment (USD, Euro, or any other specified currency). Local banks access the payment system through their central bank. Under REPSS, importers and exporters deal with their local commercial banks for trade documentation. The importer's payment to the exporter is then channeled through the central bank of the importer to the central bank of the exporter using the system's platform. The COMESA operational flow has been illustrated in **Annex 2.3**.

The system appears to be similar to a multilateral netting mechanism. However, as in the SML, this system too involves net settlement in convertible currency.

2.5.3 LCS initiative

Recently, a few Central Banks have proposed a Local Currency Settlement (LCS) framework with India to promote wider use of local currencies to facilitate and boost trade and investment settlement, including remittances. This LCS framework and bilateral currency swap framework are supposed to become a catalyst for the financial market deepening and stability in the region with monetary coordination by central banks. The utility of bilateral currency swaps between central banks, for trade, investment and remittances in the LCS framework will provide liquidity, and backstop support. The LCS framework will slowly obviate the need for maintaining large foreign exchange reserves in the long run.

2.5.4 Local Currency Bilateral Swap Arrangement (LCBSA) between central banks

Another financial cooperation scheme proposed is the 'Local Currency Bilateral Swap Arrangement (LCBSA)' between central banks. It is different from the usual bilateral Currency Swap agreement made fortrade, investment and remittance. The LCBSA is aimed at bilateral financial cooperation in the form of swaps to strengthen liquidity management and boost the development of the domestic financial market to support the economic development of both participating countries. The LCBSA also aims to function as a backstop facility for the implementation of the LCS based framework. The LCBSA would serve as a regular facility to support each country's foreignexchange reserves management, even under normal global economic and market conditions. The LCBSAmay be utilised at any time without having to formulate specific eligibility criteria.

The IDG feels that LCS, given its comprehensive approach, may be useful as a favourable model to be adoptedfor bilateral transactions, outside the USD ambit for trade/capital/remittance settlement and transfers. Opening of non-resident accounts in respective domestic currencies would enable such transactions. Further, it can contribute to the gradual development of currency markets, including the development of hedging instruments thereby facilitating direct currency quotes.

After examining the cross-country experiences on internationalisation, the IDG feels that while continuingto adopt a gradual and calibrated approach towards liberalisation, the use of local currencies can be expanded, particularly with the largest trading partners. This would require liquidity arrangements through bilateral swaps between central banks, augmented by efficient settlement through LCS and improved access to international investors forinvestment in domestic markets.

3 Approach to bring about greater internationalisation of INR

Chapters 1 and 2 of this report provide the theoretical framework and cross-country experience on the internationalisation of a currency. Based on this background, this Chapter describes the approach adopted by the IDG to further the goal of internationalisation of INR and the initiatives already taken by India towards this end. The approach of the IDG is based on the basic premise that the internationalisation of a currency should be a least disruptive process to the extent possible. It should be a continuous process of change in the financial architecture of the Indian economy thereby stimulating the international usage and demand for INR. This chapter is divided into two parts. Part A discusses the approach of the IDG towards the objective of internationalisation of INR. Part B discusses the various initiatives taken by India, so far, towards this end.

Part A- Approach towards internationalisation of INR

3.1 Capital Account Convertibility (CAC)

Free capital mobility, or internationalisation of capital markets, is commonly recognised as an engine of economic growth. Internationalised capital markets have *inter alia*, the following well recognised benefits:

i) Broadening the investor base for country's financial assets.

ii) Improve liquidity in the domestic financial markets.

iii) Induce positive pressures for market infrastructure and market practices.

iv) Enable access to a global savings pool thereby reducing borrowing costs.

v) Facilitate better risk allocation and enhance global liquidity.

Thus, while it is essential to continue on a calibrated path towards CAC, it would require continued efforts to improve macroeconomic fundamentals and financial market infrastructure with an enhanced risk management framework. The IDG feels that strengthening of these parameters is required even for internationalisation of INR as much as it is required for fuller CAC. However, the IDG opines that capital account convertibility is not a pre-condition for internationalisation of INR or *vice-versa* (as seen in the case of the Renminbi). While the two (CAC and internationalisation) are closely intertwined concurrent processes, each feeding into the other, the IDG is of the view that internationalisation of currency can be achieved to a substantial extent, independent of full capital account convertibility.

Hence, the IDG also views the realisation of the pre-conditions/signposts[21] defined in the Report of the Committee on Fuller Capital Account Convertibility, 2006 (Chairman: Shri S. S. Tarapore) as "a work in progress". Over the years, we have taken various capital liberalisation measures which have positioned us closer to a fuller CAC. India is transiting in this space with increased financial market integration and freer non-resident access to the debt market. The progress towards CAC will only increase with each such measure, especially as the Indian economy normalises after the substantial twin shocks of the COVID pandemic and the Ukraine conflict.

[21] (1) Gross Fiscal Deficit of the Centre as a percentage of GDP, (2) Inflation rate, (3) Gross non-performing assets (GNPA) as a percentage of total advances, and (4) Average effective Cash Reserve Ratio (CRR) for the banking system.

3.2 Liquidity in INR/Local Currency

Encouraging the international usage of INR requires that sufficient INR liquidity is available at the government and central bank levels (both domestic and foreign). This will provide the requisite confidence to all stakeholders, economic agents and market participants for settling cross-border transactions in INR. With the increase in financial flows globally, there has been greater volatility in forex markets. As seen during the recent COVID pandemic and Ukraine conflict, this volatility transmits shocks through the external sector, and brings macroeconomic and financial sector instability, especially in the EMEs. To manage such volatility and the risks arising therefrom, the IDG observes that the mechanisms of local currency settlement and local currency swap arrangements may prove useful for policymakers to reduce the dependency on convertible currencies for cross-border trade transactions and payment obligations. Local currency settlement provides currency diversification benefits and acts as a natural hedge against currency risk exposure, reduces transaction costs through more efficient direct exchange rates, and facilitates faster payment transfers. Similarly, local currency swaps may also be an important tool for reducing and managing financial risks because they increase liquidity in both the counterpart country and the domestic banking sector.

Further, at the level of commercial banks also, sufficient INR liquidity would be required to facilitate transactions in INR through their offshore branches. The IDG, therefore, has studied the extant Foreign Exchange Management Act (FEMA) provisions, regulations, and guidelines, as well as reviewed the existing payment and settlement infrastructure that determines the capability to provide sufficient INR liquidity, irrespective of the geographic locations and time zones. The IDG feels that the availability of INR liquidity would be crucial for INR to be accepted internationally as a settlement currency. The concerns on extending such liquidity have also been studied by the IDG with respect to any potential risk from the monetary policy angle. The IDG opines that these concerns can be handled on a case-to-case basis when the individual LCS/swap arrangements are being agreed upon with the respective partner country depending on various parameters such as the bilateral/multilateral terms of trade, the quantum of liquidity requirement and macroeconomic conditions of the partner country.

3.3 Cross-border payment infrastructure

Availability of a robust INR-denominated payment mechanism for cross-border transactions and providing timely inter-bank transfers and settlement is an important step towards the internationalisation of INR. The availability of such payment infrastructure ensures a seamless flow of cross-border transactions in local currencies. This, apart from a reduction in transaction cost, may also reduce our dependence on international payment systems based on the SWIFT messaging system. The IDG has focused on leveraging India's advanced payment systemslike Real Time Gross Settlement (RTGS), National Electronic Funds Transfer (NEFT) and Unified Payments Interface (UPI), whose potential has been recognised globally, for achieving greater internationalisation of theINR at a faster pace. The process followed by the RBI and the Monetary Authority of Singapore (MAS) to linktheir fast payment systems, UPI and PayNow respectively, has been studied by the IDG and it advocates further such projects with other countries. Further, the IDG has also examined the Continuous Linked Settlement (CLS) system, which currently settles trades in 18 currencies, and has examined the scope of inclusion of INR in thesame. The broader objective that the IDG envisages is that as the payment system is leveraged for cross-border trade transactions, it would ultimately enable the development of an Indian Clearing System (ICS) on similarlines, *albeit* on a smaller scale, to the CLS.

3.4 Extant provisions - FEMA/FTP Guidelines and Accessibility and KYC Regulations

The groundwork of enabling the whole framework of internationalisation of INR would not be possible if the extant regulations and guidelines do not facilitate the flow of INR-based trade transactions. The IDG, accordingly, has focussed only on those extant FEMA and regulatory guidelines which could be further eased to promote greater use of INR in international transactions/settlement, including access to markets for risk management. The IDG has also examined the extant incentives provided by the Government of India (GoI) for invoicing and settlement of trade in freely convertible currency so that a comparative analysis of differences in those incentives *vis-à-vis* incentives for settlement in INR can be gauged.

The approach of the IDG has also been to examine various issues on easing of non-residents' access to the various financial services available, including avenues to invest surplus INR. Associated issues like the need for revisiting Know Your Customer (KYC)/Anti Money Laundering (AML) requirements and steps to remove frictions in the current Financial Action Task Force (FATF) and Prevention of Money Laundering Act (PMLA) provisions would be very important in this regard. Further, procedural and documentation roadblocks faced by various investors, like foreign portfolio investors, need to be reviewed. These roadblocks not only add to transaction and compliance costs but also affect the overall ease of doing business in India. Hence, while highlighting these issues, the IDG has made several recommendations, which would help remove these roadblocks.

3.5 Deepening Indian Financial Markets

Well developed and sophisticated domestic financial markets give confidence to foreign investors to take exposure in the underlying currency. The IDG has deliberated on the issues in financial markets, which indicate complexities in the extant Foreign portfolio investment (FPI) regimes. Further, the need forgreater liquidity in the derivative markets has been examined by the IDG. The IDG feels that the growth and sizeof the offshore market have implications for price discovery of the INR exchange rate *vis-à-vis* other domesticcurrencies of trading partners. Therefore, the IDG's approach has been to examine ways of facilitating incrementalbut gradual access to the onshore financial markets. The IDG has also examined the ways of promoting India as the hub for INR transactions.

3.6 Approach for Long Term - Scope of INR to be used as a "Vehicle Currency"

INR has gained prominence over the years. In terms of the overall ranking across currencies for the over-the-counter (OTC) foreign exchange turnover, the INR was ranked 16 in 2019, higher than the previous rank of 18 in 2016. In growth terms, global INR forex transactions have recorded a growth rate of 96.1 per cent in average daily OTC total foreign exchange turnover between 2016 and 2019. As we progress and achieve a higher level of trade linkages with other countries, along with greater CAC, deep and liquid financial markets and strong macroeconomic indicators, it is expected that INR would be used by other economies for pegging their currencies, which will fulfil the requirement of INR being used as a "vehicle currency"[22] by other jurisdictions in their forex intervention to maintain the value of their currency. The IDG has approached this as a long-term goal which, it feels, would be a consolidated result of the various measures taken hitherto and the measures recommended in this report. Going forward, expanding trade relations with other economies, especially where Indian firms may

[22] Devereux, Michael B., and Shouyong Shi (2013). "Vehicle Currency", International Economic Review, vol. 54, no. 1, JSTOR.

have some competitive advantage and can act as a price-maker, would help boost the acceptability of the INR as a global currency.

Part B- Past and current initiatives towards the Internationalisation of INR

Based on the overall approach of the IDG as elaborated above, we discuss some of the initiatives and steps that India has already taken over the years towards the internationalisation of the INR.

3.7 Indo-Nepal Remittance Facility Scheme

This Scheme was launched by the RBI in May 2008 as an option for cross-border remittances from India to Nepal with a special focus on the requirements of migrant citizens of Nepali origin working in India. The Scheme leverages the NEFT ecosystem available in the country for the origination of such remittances and entails a ceiling of ₹2,00,000 per remittance (cash remittance limited to ₹50,000 with a maximum of 12 remittances in a year). The beneficiary receives funds in Nepalese Rupees through credit to her/his bank account maintained with the subsidiary of State Bank of India (SBI) in Nepal or through an agency arrangement. Outward remittances for other than individuals are similarly permitted as per limits decided bythe Reserve Bank from time to time.

3.8 Bilateral Swap Arrangements (BSA)

India currently has a BSA with Japan for an amount upto USD 75 billion as a backstop line of support in case of any balance of payments issue. RBI also provides liquidity to South Asian Association for Regional Cooperation (SAARC) countries under the SAARC swap framework. Under the SAARC swap agreement, the requesting central bank can make withdrawals in USD, Euro and also in INR.

3.9 Developments in the GIFT City

Gujarat International Finance Tec-City (GIFT City), Gandhinagar was set up as India's first International Financial Service Centre (IFSC) with a vision to bring to the Indian shores, those financial services/markets and transactions, relating to India, that are currently done outside India. The activities of the IFSC are governed by guidelines issued by IFSC Authority. It currently hosts Financial Market Infrastructures (FMIs), such as two international exchanges (India International Exchange (IFSC) Limited - India INX and NSE International Exchange - NSEIFSC), a depository (CDSL IFSC Limited) as well as a banking infrastructure with most of the leading banks in India participating through their banking units.

GIFT IFSC has the potential to develop as a competitor to international financial centres for Rupee products and more specifically Rupee derivatives, given the fact that the Rupee derivatives are among the most traded contracts globally. To cater to the global demand for Rupee products, non-deliverable OTC and exchange-traded Rupee derivatives are now allowed at GIFT IFSC. It also provides an opportunity for Indian entities to raise foreign capital through masala bonds and list the same on the exchanges in the IFSC.

3.10 Indo-Iran Agreement

Post sanctions against Iran, its trade transactions were kept outside the ACU mechanism. Accordingly, an agreement was signed between India and Iran for undertaking eligible trade transactions using INR. In terms of the existing Arrangement for Bilateral Trade Payments between India and Iran (2018), it was decided that Indian Rupee vostro accounts may be opened by designated Iranian banks with a few banks in India assigned for this purpose. Under the arrangement, the Indian Rupee vostro accounts of Iranian banks are credited 100 per cent in INR by Indian importers, against invoices payable for the supply of goods and services from entities in Iran, without the requirement of any additional certification or authorization.

3.11 Asian Clearing Union

The idea of initiating the use of domestic currencies within the ACU mechanism is to facilitate the process of internationalisation of INR on a pilot basis in a closed environment where the framework can be tested, and various operational glitches and roadblocks could be addressed. Accordingly, RBI had proposed the use of local currencies of members for settlement of ACU transactions thus mooting the idea of INR also being included as one of the settlement currencies under the ACU. The proposed expansion of ACU, by including more countries s, would further this process as this would increase the geographical reach of the ACU mechanism. The details of the proposal and the process ofoperationalisation of INR as an alternate currency in ACU are placed in **Annex 3.1.**

The usage of domestic currencies in the ACU mechanism would also require examining the various areas where the trade surpluses can be utilised, such as for investing in FDI, FPI, interest-bearing fixed deposits, government securities, corporate bonds or netting through invisibles, including tourism. As India runs a trade surplus with most countries in ACU, India will be acquiring the currencies of other countries, which may be deployed in the financial markets of respective countries/acquisition of strategic assets or netting from invisibles.

3.12 INR as a Designated Foreign Currency in Sri Lanka

Sri Lanka is currently facing a balance of payment crisis with a shortage of foreign exchange reserves. Though, there has been an agreement by IMF to bail out the country to the extent of USD 2.9 billion, the same is conditional on the successful restructuring of the present debts of Sri Lanka. Various facilities have been offered by India to Sri Lanka, viz., SAARC Swap facility, deferment of ACU dues and LoC by Indian banks One of the possible solutions to the present forex shortage and sustenance of imports by Sri Lanka during this period would be to look for alternative trade payments, i.e., by using local currencies of neighbouring trading partners for bilateral trade, etc. With effect from July 11, 2022, an additional arrangement for payment and settlement of exports/imports in INR has been put in place. This has been done to promote the growth of Indian trade with partner countries with an emphasis on export promotion and to support the increasing interest of the global trading community in INR. In August 2022, Sri Lanka has also made INR a designated foreign currency. These steps have paved the way for INR-based bilateral trade between Sri Lanka and India.

3.13 Use of Indian Payment Infrastructure

There are various payment systems globally that facilitate cross-border transactions, either in a single currency or multiple currencies. The Directo a México system facilitates remittances from the USA to Mexico by linking the Federal Reserve's Automated Clearing House with the Mexican RTGS system of the Bank of Mexico undertaking the forex conversion. The Gulf Cooperative Council RTGS system was implemented for facilitating transactions within the six Gulf region countries in local currency. Further, initiatives have been taken across the world tointerlink fast payment systems operating across jurisdictions to facilitate cross-border payments and remittances. The interlinking of Singapore's PayNow and Thailand's PromptPay real-time retail payment system is one such example.

On similar lines, India has also initiated the interlinkage of UPI with Singapore's PayNow, which is expected to go live in the second half of 2022. In India, various other initiatives have also been undertaken to facilitate cross-border payments, especially personal remittances. In addition to Indo-Nepal Remittance Scheme, which is an outward payment service, that was discussed in the paras above, we also have the Money Transfer Service Scheme (MTSS), which is an inward payment service. This is available through a tie-up between reputed money transfer companies abroad, known as Overseas Principal, and agents in India where the service is connected to digital and/or mobile platforms enabling customers to undertake cross-border remittances.

Further, RBI in collaboration with the GoI and National Payments Corporation of India (NPCI) is reaching out to jurisdictions to increase the global outreach of the UPI system to facilitate cross-border transactions, including remittances. The linkages between fast payment systems across jurisdictions can enhance cross-border payment arrangements and ensure faster remittances. RBI also selected 'cross-border payments' theme in the second cohort under the Regulatory Sandbox initiative to spur innovations capable of recasting the cross-border payments landscape. The cohort sought to leverage new technologies for low-cost, secure, convenient, faster and transparent cross-border payment mechanisms. Further, to ensure continuous innovation, in September 2022, RBI announced that the second cohort on "cross-border payments" was open for "On-tap" applications.

Finally, with RBI operated centralised payment systems (CPSs), *viz*., RTGS and NEFT, operating round the clock, the required infrastructure is available, which can be leveraged to interface with similar systems in other jurisdictions to facilitate cross-border payments. RBI is also actively considering the idea of expanding the framework of Structured Financial Messaging System (SFMS) to provide the domestic payment system platform to other jurisdictions. The suggested SFMS based RTGS platform model providing the infrastructure for cross-border payments is detailed in the flow depicted in **Annex 3.2.** This could be expected to provide faster, convenient and cost-effective direct payment channels with other jurisdictions.

As can be observed from the foregoing, various steps have already been undertaken to increase the global use of INR with varied amounts of success. The status of these initiatives as also the challenges faced during their implementation are examined in further detail in the next chapter**.**

4 Review of status, impediments, and steps towardsinternationalisation of INR

The path to the internationalisation of a currency is intertwined with that of the nation's economic progress. The post-reform era from 1991 onwards has hastened the process of capital mobility and domestic financial market integration with global markets, creating a favourable ecosystem for the internationalisation of INR. The public policy roadmap towards fuller capital account convertibility and internationalisation of INR has been aimed at (i) gradually liberalising the capital account, (ii) promoting the international use of INR, and (iii) strengthening financial markets. Against this backdrop, the views of IDG on the current status of internationalisation of INR, the further steps that may be taken and the challenges therein are described in this chapter based on the broad approach outlined in Chapter 3.

4.1 Liberalising the capital account

Internationalisation of the INR and capital account convertibility are processes which are both closely and symbiotically intertwined with each other. Recent policy measures for further liberalising the capital account have tended to adopt a more principle-based approach targeted at replacing several rule-based and hard-coded provisions. Thus, recent initiatives such as the Medium-Term Framework (MTF), Voluntary Retention Route (VRR) and Fully Accessible Route (FAR) for investments by FPIs in debt securities, Revised External Commercial Borrowings (ECB) Framework (2019) and the Overseas Investment Rules and Regulations, have reinforced the overarching template of liberalisation with some macroprudential checks and balances. Procedural constraints have been relaxed to a large extent. In terms of usage of INR, major policy measures include ECB in INR and Masala bonds and expansion of scope for deposit accounts in INR for non-residents [Special Non-Resident Rupee Account – (SNRR account)]. The present position of INR provisions under FEMA, 1999, is given in **Annex 4.1**. Nevertheless, there continue to be certain extant FEMA provisions and other restrictions which may come in the way of wider international usage of the INR for cross-border transactions. The same have been elaborated below. Further, the extant provisions concerning the opening of INR accounts and providing banking services to non-residents as well as the various issues relating to the extant FPI regimes have also been discussed.

4.1.1 Extant FEMA and other provisions that need to be reviewed to allow/encourage the international usage of INR

1) RBI has already put in place an additional arrangement for invoicing, payment, and settlement of exports/ imports in INR through Special Rupee vostro account. However, specific multilateral/bilateral arrangements that mandate settlement in FCY, need to be addressed on a mutual basis. For example, contracts (for which payments are received through Asian Clearing Union (ACU)) are denominated only in ACU Dollar or ACU Yen or ACU Euro. Some countries have been permitted to settle trade transactions outside ACU mechanism due to geo-political and macroeconomic assessments. However, RBI in consultation with the Government may consider further encouraging the use of INR as the settlement currency under these multilateral/bilateral arrangements.

2) Sufficient incentives are not present for the settlement of trade transactions in INR. Export proceeds realised in Indian Rupees against exports to Iran are only permitted to avail export benefits/incentives under the Foreign Trade Policy (2015- 20), at par with export proceeds realised in freely convertible currency. This needs to be extended and made universal (for all INR-based trade transactions with all countries) by the Government.

3) SNRR accounts carry the nomenclature of the specific business for which it is in operation. An Indian bank may, at its discretion, maintain separate SNRR accounts for each category of transaction or a singleSNRR account for a person resident outside India engaged in multiple categories of transactions providedit can identify/segregate and account for them category-wise. However, the SNRR accounts' credit balances cannot be debited for purposes other than those pertaining to the said credit, for example, credits from trade transactions cannot be used for making FDI or FPI in India. SNRR account cannot also be utilised for FDI (other than by Foreign Venture Capital Investors - FCVIs), etc. Further, it is a non-interest-bearingaccount. Thus, there is a case for allowing a single SNRR account for non-residents that may be used for all permissible capital and current account transactions.

4) Indian banks are permitted by RBI to issue long-term Rupee Denominated Bonds (RDBs) overseas for financing infrastructure and affordable housing having a minimum tenor of 7 years. This is a prudential concern of matching maturities of assets and liabilities of a bank and hence this view was taken by RBI on minimum tenor while permitting banks to issue Masala bonds. However, other financial intermediaries, like Non-Banking Financial Companies (NBFCs), are permitted to raise RDBs with a minimum tenor of 3 years. This may be one of the reasons that there has been little appetite for masala bond issuances by Indian banks for a tenor of 7 years.

5) Presently withholding tax of 5 per cent applies to Masala bond issuance. This is a preferential rate of tax, which the government had permitted after due consideration, reducing it from 20 per cent applicable to other non-specified types of interest. However, even this appears to tilt the cost materially and adversely for INR-denominated ECBs through Masala bonds.

6) The extant mechanism links INR value with INR-denominated ECBs, whereas settlement occurs primarily in freely convertible currencies. A local currency settlement framework is absent.

7) There is no mechanism for providing INR finance from the Indian banking system to non-residents other than NRI/Overseas Citizens of India (OCIs).

To examine some of these issues and prescribe solutions to the challenges mentioned, there is a need for a review of the extant FEMA provisions as well as for extending incentives for international trade settlements in INR.

4.1.2 INR accounts outside India

Ability to open bank accounts in the currency of a country outside that country is a foundational element of internationalisation of a currency. An account in the currency of a resident country in the non-residents' own jurisdiction allows them to leverage their existing financial relationships and provides them the flexibility to move funds and execute financial transactions in their time zone. At present, non-residents can open only onshore INR accounts and these accounts can be utilised only for payments/receipts in respect of a limited set of permissible transactions. As part of the efforts at internationalisation of INR, we may consider settling all permissible capital and current account transactions not only through onshore INR accounts but also through offshore INR accounts.

Accordingly, and to begin with, non-residents may be allowed to open INR accounts only with the overseas branches of Authorised Dealers (ADs) for the purpose of undertaking current and capital account transactions permitted under the FEMA, 1999. At a later stage, based on the experience of implementation and readiness of the system, permitting opening of INR account with any overseas bank and without any restrictions in terms of purpose (including for transactions between non-residents) may be considered.

4.1.3 Banking Services in INR through offshore branches of Indian banks

To promote INR as an international currency, it is also necessary to increase the share of INR in international markets through greater usage of INR in trade and services and for settlement of financial market transactions. It would also require Indian banks to provide banking services (loans, guarantees, credit lines, *etc.*) in INR to non-residents.

Currently, RBI issues approval to Indian banks for opening offices abroad in terms of statutory provisions of sub-section (1) (b) of Section 23 of Banking Regulation Act, 1949. While approving, it is only mentioned that the approval is granted subject to the bank complying with the laws and regulatory requirements of the host country. Thus, business activities undertaken by the offshore branches of Indian banks are subject to host country regulations. Though, there seems to be no explicit restriction in terms of offshore branches of Indian banks providing banking services and participating in financial markets in INR, the guidelines issued till now have not considered the aspect of banking business in INR through offshore branches of Indian banks. Accordingly, there is a need to revisit the existing regulations in this context and make necessary changes as may be required.

4.1.4 Recalibrating the regime for Foreign Portfolio Investment (FPI) in debt

The regime for FPI investment in debt has been evolving within the broader context of the calibrated opening of India's capital account to external debt flows. As part of the developments on that front, new channels of investment, *viz.,* the Voluntary Retention Route (VRR) and Fully Access Route (FAR) were added to the existing Medium-Term Framework (MTF), in recent years, to cater to different investment philosophies. While these were intended to provide a bouquet of investment avenues, market feedback indicates that the extant regime appears complex. The underlying issues and possible solutions are discussed.

A) Issues

- **(i) Uncertainty under the VRR:** While investment under the MTF and the FAR limits are linked to outstanding stock of bonds and have carried predictability, such predictability is not in place in the case of VRR.
- **(ii) Complexity under the MTF:** Investment limits for Government Securities(G-secs) and State Development Loans (SDLs) under the MTF are sub-divided into 'general' and 'long-term' sub-categories. The utilization of the long-term sub-limit is low but adds to the complexity of the investment regime.

B) Possible solutions to optimise and rationalise the FPI regime

I) Government Securities:

(i) Option 1: Rescind MTF

All G-secs may be included under the FAR. This could provide the simplest regime which can send strong positive signals and can also help distribute externalinflows across the yield curve. While this does carry the risk of exposing the entire sovereign yield curve (and SDLs) to external volatility, the incremental risk it adds to the existing arrangement,where liquid G-secs, with substantial outstanding stock, are already fully open to non-residents under the FAR, is not likely to be high.

(ii) Option 2: Retain both the MTF and FAR while rationalising MTF

The macroprudential controls under the MTF may be removed while retaining the aggregate quantitative limit on investments. All segments (G-sec/SDL and General/Long-term) within the investment limit under the MTF may be merged to a single limit for investment in G-secs, SDLs and T-Bills. This method could cap the exposure to external volatility for securities covered under the MTF.

On a comparison, Option 1, appears to be the optimalway forward. Unlike certain other emerging markets that have a significant holding of government securities by foreign investors, the large domesticinvestor base in the Indian G-sec market provides comfort.

II) Corporate Bonds

(i) Imparting certainty to VRR: To foster predictability, investment limits under VRR may be set in percentage terms of outstanding corporate bonds and reviewed annually, like the MTF.

(ii) Rationalisation of macroprudential controls under the MTF: Amongst the extant macroprudential controls, the short-term limit and the concentration limit, could pose operational burden and increase compliance costs for FPIs. Hence, the MTF may be rationalised by removing the short-term limit and the concentration limit, while retaining other macroprudential controls.

Thus, there is a need for suitable amendments to the extant FEMA provisions as well as for extending incentives for international trade settlements in INR. The IDG also feels that to further the objective of internationalisation of INR, we should not only promote all permissible capital and current account transactions through onshore INR accounts but also enable the same through offshore INR accounts in a phased manner. Similarly, banking services are also required to be provided by offshore Indian banks in terms of loans, credit lines, guarantees, etc., to non-residents. In addition to this, there is a need to optimise and rationalise the FPI regime to facilitate investments into the Indian debt markets, both Government and Corporate.

4.2 <u>Promoting international use of INR</u>

To facilitate international financial transactions in INR, an efficient settlement mechanism, adequate arrangements in terms of availability of liquidity and the development of a robust cross-border payments system in INR would be required. The same are discussed in this Section.

4.2.1 Swaps and Local Currency Settlement

As financial flows have increased in the 21st century, sudden stops and reversals have also increased in frequency. This increased volatility in forex markets can transmit shocks to destabilise the external sector, and macroeconomic and financial sector stability, especially for Emerging Market Economies (EMEs). The recent COVID pandemic as well as the Ukraine conflict has proved that these risks can snowball into serious and sudden external sector vulnerabilities. Towards managing these risks, local currency settlement and currency swap arrangements are tools for policymakers to reduce dependency on convertible currencies, like the USD, for cross-border trade transactions. Further, an overview of the past and existing examples of such arrangements, especially in the Indian context, are given in **Annex 4.2**.

Local Currency Settlement (LCS) Framework

A review of the cross-country experience in Chapter 2 has shown us that a local currency settlement provides currency diversification that stabilises the local currency and provides a natural hedge for the business community to protect against currency risk exposure, reduces transaction costs through more efficient direct rates, and facilitates faster transfers. The LCS framework follows a comprehensive approach as it attempts to expansively cover issues *inter alia* relating to the establishment of correspondent banking relationships in local currencies, use of national payment systems, the requirement for bilateral domestic currency swaps, hedging, *etc*. The IDG feels that a common template can be adopted while entering into such an arrangement with the partner countries. Subsequently, a local currency swap arrangement can be explored to supplement the LCS arrangement and its emergent liquidity requirements. Local currency swaps that allow central banks to exchange domestic currencies with each other are important tools for reducing/managing financial risks. Encouraging the international usage of the INR requires that after a certain threshold level of settlement of bilateral transactions is achieved in INR, sufficient liquidity in INR is available at government to government/central bank to central bank level. Hedging may be operationally challenging for all the stakeholders while adhering to two different regimes and the position may become more complex in case more such bilateral arrangements are entered into in the future. However, it is felt that to the extent possible, these differences may be narrowed down. Accordingly, users in each country may be permitted to hedge their exposures as per the regulatory regime in place in that country with only the incremental permissions/prohibitions being stipulated. This approach will allow the market to take up the local currency settlement without much difficulty. It will also help in simplifying the framework and minimising the need for future changes.

Challenges in the context of LCS and liquidity

i. While negotiating swap lines in soft currencies, the challenge of exploring avenues for investments of surplus Local Currencies (LCYs) in the country of issuance has to be addressed. A suitable examination of the avenues, based on the mutual consent of both countries, has to be undertaken.

ii. For determining the exchange rate for conversion of cross currencies, direct quotes may not be available. Initially, the exchange rate with reference to the USD or another third currency may need to be referred to for determining the external value of the currency. Over a period of time, as the market develops and turnover reaches a certain threshold, direct quotes would also become available.

iii. Suitable cross border payment mechanisms leveraging on domestic payment systems like UPI/RTGS/ indigenous card networks need to be devised which may need considerable time for exploration and development.

iv. Financial messaging across borders is excessively dependent on the SWIFT messaging system. We may need to consider an alternative messaging system which is equally safe and secure.

There may be a challenge to promote and ensure higher footfalls in the LCS-based transactions by Indian commercial banks. The above challenges have been acknowledged by the IDG and the proposed solutions to each of these have been discussed in Chapter 5.

Overall, there is a need for formulating a framework/common template or standardised approach for Local Currency Settlement Mechanisms and bilateral trade agreements, which will help incrementally internationalise the INR.

4.2.2 INR Liquidity

As per the extant Liquidity Risk Management Framework (LRMF), banks are required to monitor their liquidity risk on a consolidated level, *i.e.*, they also need to take into account operations of overseas branches for adherence to LRMF. Under LRMF Indian banks are required to maintain Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) standards on an ongoing basis along with monitoring and reporting of liquidity returns including structural liquidity statements.

Further, LCR is required to be met in one single currency (INR). However, to better capture potential currency mismatches, the LCR in each significant currency is being monitored. A currency is considered "significant" if the aggregate liabilities denominated in that currency amount to 5 per cent or more of the bank's total liabilities.

In LCR computation, types of high-quality liquid assets (HQLAs), haircuts, adjustments, cash outflow and inflow items and their run-off rates would be the same for foreign currencies as in the case of LCR in INR. Hence, the LRMF is already reflecting the liquidity needs of the overseas Indian banking institutions (OIBIs) in INR. Further, the OIBI may have to follow additional guidelines prescribed by the local regulator.

A. Liquidity issues and solutions for overseas participants

Banks would require sufficient INR liquidity to facilitate transactions in INR through their offshore branches. Sufficient INR liquidity, fostering a global deliverable INR market irrespective of geographic location and time zones, would facilitate payment and settlement of offshore INR transactions and is therefore crucial for INR to be accepted internationally as a settlement currency. Accordingly, offshore branches of Indian banks may be explicitly allowed to open INR accounts for non-residents gradually (subject to regulatory clearance). A move in this direction would require the need to ensure enough INR liquidity in the global systems so thatthe participants can fulfil their obligations. Further, to make provision of INR liquidity to foreign entities, firstly, the country-specific limits for liquidity could be arrived at a certain initial percentage of trade volume with each of the major trade partners. Subsequently, for the overall system level, the liquidity threshold could be fixed at a certain percentage of either narrow money (*i.e.*, M0), balance sheet size of RBI, or based on the overall trade volume of India/terms of trade, or based on Net Demand and Time Liabilities (NDTL).

B. Concerns about extending liquidity

One of the issues with an international currency is the demand for currency outside the shores of the nation. Due to such external demand, there could be concerns surrounding the need for setting initial limits for such liquidity frameworks. One view is that the RBI liquidity support for INR internationalisation should be of modest amounts so that it does not impede the public policy objectives of low and stable inflation with desired growth. For example, the total RBI liquidity support for INR internationalisation (including intra-day limits) is set as a percentage of NDTL of the banking system. However, in the short run, there may notbe any impact on the money supply as any currency takes a long time to become a popular global currency among traders/investors. Further, liquidity management tools at the disposal of the monetary authoritiescan always prevent a runaway monetary expansion, resulting from automatic adjustment.

Therefore, the IDG feels that the extent of liquidity support from RBI may be decided on a case-to-case basis for each LCS based on various parameters such as the bilateral/multilateral terms of trade. The approach/ solution towards provisioning of INR liquidity is given in **Annex 4.3**.

4.2.3 Clearing of transactions in Government securities through International Central Securities Depositories (ICSDs)

Presently, non-residents that desire to invest in G-secs are required to register as FPIs. While over the years, reforms have been undertaken to facilitate ease of investments by non-residents, some of the non-resident investors may not prefer, or find it difficult, to set up an onshore presence. Such investors may like to undertake transactions in domestic assets in offshore markets through ICSDs.

To tap the demand for G-secs by non-residents, announcements on allowing international settlement of Indian debt securities were made in the Union Budget Speech of 2014-15 and the Bank's Statement on Developmental and Regulatory Policies dated April 4, 2019. Enabling the clearing of G-secs through ICSDs would allow non-residents to invest from outside India without having to register as FPIs. ICSDs, such as Euroclear and Clearstream, have been enabling such non-resident investments in many jurisdictions. Clearing through ICSDs has the potential to increase the participation of non-residents in the G-sec market and lower borrowing costs[23] for the Government by expanding the investor base in the G-sec market. The potential risks include shifting of onshore liquidity tothe offshore market, the development of a parallel yield curve, *etc*.

4.2.4 Cross-border payment system linkages - Extension of the global reach of RTGS, NEFT, UPI and Rupay Cards

The journey of payment systems in India has been phenomenal in the recent years. The recently released Payments Vision 2025 sets an ambitious, yet achievable target, for payment systems in the country. The dynamic and accelerated development of the payments ecosystem in India, facilitated by increased adoption of technology and innovation, has established the country as a force to reckon with in the global payments space, in terms of not only growth in digital payments but also the availability of a bouquet of safe, secure, innovative and efficient payment systems. Over 30 crore digital payment transactions are processed daily by our payment systems, of which the UPI system itself processes more than 70 per cent.[24] One of the important goalposts of the Payments Vision 2025 is the "internationalisation" of payment systems.

The availability of a robust 'INR denominated payment mechanism' for cross-border transactions providingtimely settlements and inter-bank transfers is an important concomitant towards internationalisation of INR.The availability of such payment system linkages will ensure a seamless flow of payments for cross-border retail

[23] A 2019 study by PwC showed that access of sovereign bonds through Euroclear reduced borrowing costs by about 28 bps (on an average).

[24] Payments Vision 2025, June 2022. https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/PAYMENTSVISION2025844D11300C884DC4ACB8E56B7348F4D4.PDF

payments during travel and remittance flows in domestic currencies between the two countries. Singapore has a large number of Indian workers and students, resulting in substantial (more than USD 1 billion) in-bound and out-bound remittances every year. The UPI-PayNow linkage is expected to be a significant milestone in the development of infrastructure for cross-border payments between India and Singapore and aligns with the G20's financial inclusion priority of enabling faster, cheaper and more transparent cross-border payments. It can also contribute to fulfilling United Nations (UN) Sustainable Development Goals (SDG 10.c) by reducing the cost ofremittances. Further details of the system are in **Annex 4.4.**

4.2.5 Continuous Linked Settlement

Continuous Linked Settlement (CLS) is a global system for the settlement of foreign currency transactions on a Payment vs Payment (PvP) basis. The CLS system currently settles trades in 18 currencies. However, INR is not a settlement currency in CLS. Banks in India (overseas branches of Indian banks are also being enabled for inclusion) participate in CLS, through the third-party settlement services provided by Clearing Corporation of India Ltd (CCIL), for the existing 18 currencies.

Considering the growth in the Indian economy and the increase in trade, it is felt necessary that INR is also included as a direct settlement currency in CLS (for being a member of CLS the country's currency need not be fully convertible). The process of including a currency in CLS may take two to three years, as CLS does a thorough analysis of the legal aspects of clearing and settlement in the country.

Impact of Inclusion of INR in CLS towards internationalisation of INR

The inclusion of INR as a currency will bring visibility to INR. With this, INR can be purchased against other currencies enabled in CLS for making INR-denominated current/capital account transactions. Most currencies enabled in CLS are major currencies. Therefore, if a country, say Indonesia, desires to purchase INR through CLS, it will require to purchase it against any of the 18 currencies, thereby limiting its usage. Initially, the inclusion of INR in CLS may have a small impact on the internationalisation of INR but this could scale up with the increase in demand for INR for direct conversion depending on willing countries for using the platform for purchase of INR against other currencies.

4.2.6 Creation of an Indian Clearing System (ICS)

Enabling a currency settlement system with wider participation of currencies could go a long way towards the usage of domestic currencies in bilateral trade and in the process, enhancing the use of INR. The clearing system would provide its member banks with a market to purchase currencies against their domestic currency. A broad outline of the proposed framework is given in **Annex 4.5.** The IDG feels that the gradual creation of an Indian Clearing System will bring greater efficiency in the settlement in domestic currencies, by carving a marketplace for these currencies that are not freely convertible. Thus, it would help enable the development of a vibrant forex market in such currencies. This is also in line with RBI's Vision Document 2025 fifth anchor goal post, *i.e.,* internationalisation of payments and settlement system.

4.2.7 INR as a vehicle currency/contender to SDR basket:

As we progress and achieve a higher level of trade linkages with other countries, along with improved CAC, deep and liquid financial markets and strong macroeconomic indicators, it is expected that INR would be used by other economies for pegging their currencies, which will fulfil the requirement of Indian currency to be used as "Vehicle Currency" by other jurisdictions in their forex intervention, while maintaining the value of their currency. In this regard, India has to encourage trade invoicing in INR by expanding trade relations with other economies, where Indian firms may have some competitive edge and can act as price-makers, which would help to boost the acceptability of the INR as a global currency (more details on this have been mentioned in **Annex 4.6**).

Thus, as elaborated above, the IDG is of the view that in order to manage the external sector vulnerabilities and reduce dependence on convertible currencies, there is a need to enhance swap arrangements on a bilateral basis with willing countries and also develop a Local Currency Settlement framework enabling smooth trade based on domestic currencies. For this, sufficient liquidity has to be ensured in the global systems. The concerns arising out of these liquidity arrangements can be managed on a case-specific basis by taking into account the various internal parameters as well as those of the partner counterparty country. Participation of non-residents in the G-sec market through ICSDs can further expand the G-sec investor base and help in lowering the cost of Government borrowings. Lastly, leveraging our efficient payment systems and initiating the process of inclusion of INR in CLS have a strong potential to promote the internationalisation of INR. Going further, it is felt that for attaining the objective of INR as a "Vehicle Currency", the Bank may target its inclusion in the SDR[25] basket.

4.3 Strengthening the Financial Markets

Historical experience shows that well developed financial markets are a key element in the use of a currency as an international vehicle currency (BIS, 2011). Well developed and sophisticated domestic financial markets give confidence to foreigners to invest and transact in a currency. To support the measures for further opening of the capital account, promoting INR invoicing and promoting offshore INR transactions, steps may be taken to strengthen the financial markets. RBI has been taking calibrated measures for liberalising and developing the financial markets, such as:

i) Moving towards a more principle-based regulatory framework;

ii) Strengthening customer protection for the retail customer[26];

iii) Promoting product innovation for sophisticated customers;

iv) Introducing non-deliverable forex derivatives in the onshore market[27];

v) Enactment of netting legislation and implementation of the margin requirement for non-centrally cleared derivatives[28];

vi) Implementing a regulatory framework for market conduct (prevention of market abuse); and

vii) Implementing regulatory framework for important financial infrastructures like trade repository, benchmark administrators, electronic trading platforms and legal entity identifier.

[25] SDRs were created as supplementary international reserve assets in the context of the Bretton Woods fixed exchange rate system.

[26] Through disclosures (about mid-market marks, product and risks) and specifying permissible products for retail customers.

[27] Currently, allowed only for customer transactions with non-resident users and inter-bank transactions (local and cross-border).

[28] Variation Margin Directions have been issued; Draft Initial Margin Directions have been issued for public feedback.

The recent measures taken by the Bank have significantly changed the regulatory landscape, creating a conducive ecosystem for taking the financial markets to the next level of development and sophistication.

4.3.1 KYC and registration requirements for non-residents including FPIs

Internationalisation of the INR requires non-residents (NRs) to acquire, hold and dispose of financial assets in India with ease. This will encourage NRs to maintain INR-denominated accounts, the balances of which couldbe freely utilised for gainful investment in Indian financial markets. The feedback/suggestions on procedural and documentation issues as received from market participants are highlighted in this section.

(i) Harmonisation of KYC norms of RBI and SEBI to take care of category of FPIs, KYC documentation and certification of Officially Valid Documents (OVD)

Investors and custodians have been indicating in various forums that Indian KYC regulations are relatively more stringent compared to international financial centres. Securities and Exchange Board of India (SEBI) has made certain changes to their regulations to simplify the KYC process. To ease access of foreign investors to INR assets, efforts may be undertaken to harmonise the KYC regulations of RBI and SEBI.

(a) **Category of FPIs:** The SEBI's operational guidelines recategorised the FPIs in two categories from three earlier. Most of the FPIs in category II were recategorised as Category I. The RBI's Master Direction (MD) for Know Your Customer (KYC), however, still consists of three categories. The KYC requirements differ for these three categories.

(b) **KYC documentation:** The revised SEBI guidelines did away with most of the KYC documentation for authorised signatories and the Ultimate Beneficial Owner (UBO). Details such as name, nationality, date of birth, address and Government issued ID number are disclosed in the Common Application Form (CAF). Now, only the document for proof of identity of the UBO is required by SEBI. The RBI's Master Direction still requires the FPIs to submit proof of identity documents for both authorised signatories and UBO.

(c) **Certification of Officially Valid Documents (OVD):** SEBI KYC requirement permits copies to be attested by entities authorised for attesting the documents like notary public/officials of multinational foreign banks or any bank regulated by RBI. The RBI's Master Direction, on the other hand, requires banks to collect certified copies of OVD by comparing a copy of the OVD with the original. While it accepts notarised documents for NRIs, there is no such provision for the other non-residents.

(ii) KYC at investment manager level instead of fund level

The current KYC requirement for FPIs is at each FPI level which means that for every scheme/fund of an investment manager, the entire KYC is repeated. The funds/schemes of an investment manager usually differ only by their prospectus while most of the other information remains the same.

(iii) KYC reliance on Global Custodians and third parties

Market participants suggest acceptance of KYC performed by Global custodians (GCs) for entities coming through global custodians for registration. GCs typically appoint one or more local custodians to service their client accounts in India. The local market servicing arrangements operate under an agreement that runs between the GC and the local custodian. GCs follow global KYC procedures that consist of having robust customer identification programs in general, including the use of a risk-based approach to customer due diligence under which enhanced due diligence is conducted for customers that fall into high-risk categories. GCs are themselves subject to standardised KYC and AML-related procedures for customer onboarding. The prescribed KYC requirements for non-residents under the extant banking regulations were examined at length and it was felt that there are no specific instructions in the Master Direction on KYC for non-residents except in case of (a) non-availability of address in the OVD of foreign national, (b) additional certifying authorities for NRI/Persons of Indian Origin (PIO) customers, and (c) relaxations for FPIs.

(iv) FPI registration process - common ownership/control criteria

As per SEBI's, FPI Regulations, 2019, the purchase of equity shares in a company by a single FPI including its investor group should be below 10 per cent of the total paid-up equity capital on a fully diluted basis of the company. Further, 'investor group' is defined as multiple entities registered as FPI and, directly or indirectly, having common ownership of more than 50 per cent or common control.

Investor group details are obtained at the time of the FPI registration process in the Common Application Form (CAF). Providing investor group details is challenging for large financial institutions with multiple group entities already registered as FPIs or seeking fresh registration across multiple Designated Depository Participants (DDPs). Such applicants are required to reach out to other group entities to ensure fulfilment of the common ownership/control criteria before finalising CAF.

The issue becomes more cumbersome when multiple FPI applications are being processed across multiple DDPs.

(v) Processing of applications on scanned copies – post-facto collection of original documents

At present, the application is only processed on receipt of the original documents. This causes some delay in the processing. The transit period could be even longer if the FPI forwards physical documents to GC who in turn redirects the same to the custodian in India.

(vi) Acceptance of digital signature/digital certification

Current regulations require intermediaries to collect physical forms/letters signed by authorised signatories. It is understood that there currently exists applications providing 'digital signature' solutions that can be used as an alternative to 'wet ink' signatures on documents. Many advantages in turnaround time and efficiency are expected to accrue by permitting this.

(vii) Reliance on SWIFT confirmation from Global Custodian (GC) Banks in lieu of wet ink attestation on the physical document

Current regulation requires intermediaries to collect physical copies of notarised/bank-attested documents. In lieu of the above, DDPs/Custodians should be allowed to accept a scanned copy of documents received from Global Custodian bank along with the SWIFT confirmation from the GC bank specifying the list of documents being attested.

4.3.2 Integration of onshore and offshore markets

In March 2020, AD Cat-I banks having an operational IFSC Banking Unit (IBU) were allowed to deal with INR non-deliverable forex derivative contracts (NDDCs), with effect from June 1, 2020. One of the primary objectives of this measure was to remove the segmentation between onshore and offshore markets and improve the efficiency of price discovery. Indian banks have now been accessing the Non-deliverable Forward (NDF) markets for more than two years. This policy initiative has had positive effects in terms of greater convergence of spreads between onshore and offshore markets. However, the activity of Indian banks in offshore markets has remained concentrated. The share of transactions' turnover handled by AD Cat-I banks in the offshore market has remained below 10 per cent of the overall turnover. Due to the requirement of having an IBU, a section of AD Cat-I banks is not eligible to deal in Rupee NDDCs leading to a loss of opportunity. Such ADs account for about half of the interbank and about one-third of the customer activity in the domestic market (as shown in table 4.1 below).

Table 4.1 : Activity in the onshore Rupee forex derivative market (Feb 2022)

Transaction	**Contribution in outstanding**		**Contribution in turnover**	
	AD Cat-I banks without IBU	**AD Cat-I banks with IBU**	**AD Cat-I banks without IBU**	**AD Cat-I banks with IBU**
Interbank transactions	50%	50%	46%	54%
Customer transactions	36%	64%	38%	62%

Source: CCIL Trade Repository Data.

Efficient integration of the onshore and offshore markets can be fully achieved only with the participation of all domestic banks in the Rupee NDDC market. The same has been elaborated in **Annex 4.7**.

4.3.3 Promoting India as the hub of INR transactions and the main centre for INR price discovery

The 2019 edition of the BIS Triennial Central Bank Survey indicates that a market about twice the size of the onshore INR market exists overseas (mainly in London, Singapore and Hongkong). The growth and size of the offshore market has implications for the price discovery of the INR exchange rate. Against this backdrop, promoting India as the hub for INR transactions and the main centre for price discovery of INR rates is an important regulatory objective.

A critical enabler for this will be the development of a formidable liquid onshore INR NDF (and other non-deliverable products) market which combined with the existing onshore INR spot, OTC and exchange liquidity has the potential to attract offshore volumes. Achieving this objective will require concerted efforts to garner liquidity both from non-residents as well as residents.

Several steps, as enumerated above, have been taken to ease access of non-residents to domestic financial markets. However, various structural and behavioural issues, *viz.,* taxation laws, established relationships and familiarity, *etc.* make the transition (non-residents migrating from offshore market to onshore market) difficult and slow. Strong incentives are required for attracting non-residents to trade in the onshore market. Liquidityand depth are among the most important parameters that influence the decision of undertaking transactions ina particular market.

As per the extant regulatory framework, customers can undertake INR forex derivative positions (OTC and exchange-traded) to hedge only (except non-resident users who can undertake non-deliverable INR forex derivatives without the requirement of underlying exposure). This limits the liquidity and depth of domestic markets. One of the main reasons for the rapid growth of offshore markets is their ability to undertake derivative transactions without the requirement of an underlying exposure and/or the requirement to demonstrate the existence of underlying exposure.

In the onshore market, this requirement is stipulated as part of the capital account and exchange rate management framework. However, the volatility from view-based positions in offshore markets is already being transmitted to the onshore market through various inter-market linkages. Further, participantswith large positions, *viz.,* ADs, stockbrokers and non-resident investors are already permitted to take view-based positions in the onshore market (*albeit* in the case of the ADs and stockbrokers, such positions are subject toposition limits).

Against this backdrop, allowing participants to freely access the onshore forex derivative market without the need for underlying exposure may help further enhance liquidity in the onshore market and thereby promote it as the main centre of INR price discovery. Incidentally, the need for an underlying exposure has been removed in related derivative markets, *viz.*, interest rate and credit derivative markets for non-retail (larger) customers and there is no requirement for an underlying exposure in the case of equity derivatives.

It is felt that this liberalisation may be undertaken in a phased manner. In the first phase, resident users may be allowed to undertake non-deliverable INR forex derivatives without any restrictions in terms of purpose, bringing them at par with non-resident users. In subsequent phases, users (both resident and non-resident) may be allowed to access the exchange-traded and the deliverable forex derivative markets without any restriction in terms of purpose.

4.3.4 Global 24x5 INR market

The current regulatory framework facilitates 24x5 INR forex transactions by allowing (a) the onshore market to function without any time restriction; and (b) AD Cat-I banks to undertake forex transactions with non-residents from their domestic branches or through their overseas branches and subsidiaries, as illustrated below.

Table 4.2: Current regulatory framework for forex transactions

#	Transaction	Venue
	Customer Transactions	
1	INR FX Spot	From domestic branches and through overseas branches and subsidiaries
2	INR Deliverable FX Derivative	
3	INR Non-Deliverable FX Derivative	
	Inter-Bank Transactions	
4	INR FX Spot	From domestic branches only
5	INR Deliverable FX Derivative	
6	INR Non-Deliverable FX Derivative	

It is observed that while customer transactions are facilitated round-the-clock in the offshore market, the inter-bank market operates through Indian branches only and operates only for a limited set of hours onshore[29]. For INR to be accepted internationally, it is important that a liquid inter-bank market is available globally and on a

[29] While onshore markets is functional 24x5, liquidity remains thin outside the regular normal market hours.

24x5 basis. In international currencies, dealers transfer the books in the financial centre that is open as per its time zone, thereby ensuring round-the-clock liquidity across the globe.

To foster a global 24x5 INR market, it would therefore be important that inter-bank forex transactions are also permitted to be undertaken through overseas branches and subsidiaries of AD banks, thus enabling AD Cat-I banks to make a market in INR round-the-clock. In the first phase, all inter-bank transactions between two AD Cat-I banks may be permitted while deliverable inter-bank transactions between AD Cat-I bank and an overseas bank may be permitted only for fulfilling the INR requirements of the overseas bank (funding the INR nostro account, hedging, *etc*.). Similarly, market-makers in the interest rate derivative market may also be allowed to undertake customer and inter-bank transactions through their overseas branches and subsidiaries in addition to dealing from their domestic branches. This will ensure that a bouquet of INR forex and interest rate products is available internationally on a 24x5 basis without the necessity of round-the-clock operations of the onshore market. As a complementary measure, the possibility of extending the operational hours of CCIL-operated trading platforms, *viz*., FX-CLEAR, FX-SWAP and Anonymous System for Trading in Rupee OTC Interest Rate Derivatives (ASTROID) to enable overseas branches and subsidiaries to continuously discover prices and provide liquidity could also be examined.

4.3.5 Deepening of Debt Market in India - BISIP in INR

BIS Asset Management offers dedicated portfolio management services tailored to each central bank customer's preferences. BIS Investment Pools (BISIPs) are open-ended fund structures that allow customers to invest in a common pool of assets. The BISIP structure was initially used for US dollar and Euro-denominated bond portfolios. In the last few years, additional funds have been launched in cooperation with some central banks, including the BISIP ILF1 (invested in US inflation-protected government securities), the BISIP CNY (invested in domestic Chinese sovereign fixed income securities) and the BISIP KRW (invested in domestic South Korean sovereign fixed income securities). In this context, the possibility of a BISIP-INR may be viewed positively as eventually these investments will lead to a deep and liquid bond market. Also, investment through BISIP in G-secs may increase the level of foreign exchange reserves, which are expected to be stable inflows as the investors in BISIP-INR will be central banks. The IDG feels that such a fund may act as a step towards internationalisation of INR in that (i) it will eventually lead to acceptance of INR as a reserve currency, which in turn may aid the inclusion of INR in the SDR basket, and (ii) it will provide a platform for integration of Indian financial market with global financial markets and in turn contribute towards encouraging the inclusion of Indian government securities in global bond indices.

4.3.6 Inclusion of Indian Government Bonds in Global Bond Indices

While foreign investors have been permitted to invest in G-secs, their participation has been below the levels seen in other emerging markets. One of the probable reasons is that India is the notable exception amongst major emerging markets that does not feature in global bond indices. There are several advantages of getting included in global bond indices, *viz.,* (a) *Widening of investor base:* The non-resident investor base in Indian government bonds has largely remained stagnant resulting in continued reliance on banks and other institutional investors, such as insurance companies to support government borrowing needs. Tapping the large assets under management (AUM) of funds tracking global bond indices will help in meeting the growing borrowing needs of the country; and (b) *Stable passive flows*: Globally, there is an increasing trend of passive investing, especially by large investors such as pension funds, insurances, *etc.*, by following the bond indices. The AUM of funds tracking the three major global bond indices (JP Morgan, FTSE Russel and Bloomberg-Barclays) combined is more than USD 5 trillion. Funds following the indices are generally stable flows and tend to be more stable than other FPI flows. Countries that are not part of Global bond indices can only receive second-order flows from active investors.

The experience of other countries has testified to the positive impact of their inclusion in global bond indices on the country's structural balance of payments position by ushering in an environment of lower cost of capital and higher growth. There are several reports highlighting the potential long-term benefits of liberalising India's bond market and inclusion in the global bond indices. The likely benefits include large immediate inflows on inclusion in one or more global bond indices followed by steady incremental annual inflows, flattening of G-sec yield curve, appreciation of the INR, reduction of overall borrowing costs with tightening of bid-ask spreads, improvement in foreign flows to corporate bonds, *etc*. However, it cannot be denied that there are associated risks linked to such index inclusion like increased sensitivity of domestic policy to external spillovers; fiscal and monetary policies need to be more cognizant of global perception and sensitivities, the potential cost for sterilisation and associated market operations owing to large inflows. However, such risks generally materialise when concerns emerge about the fiscal health of the country with potential rating downgrades or de-platforming from the index. The improving macro-stability conditions of India provide comfort in this context. On the whole, the benefits of index inclusion appear to outweigh the concerns associated with it.

RBI has been engaging with index providers, *viz.,* JP Morgan, FTSE Russel and Bloomberg-Barclays for the inclusion of IGBs in global bond indices. These interactions suggest that there is increasing interest in the inclusion of Indian Government Bonds (IGBs) in global indices given the reforms carried out in financial markets, including markets for hedging of interest rate and currency risks, opening up of bond markets to investors, operationalisation of FAR, *etc.* India is already on the watch list for inclusion in two indices (JP Morgan Global Bond Index – Emerging Markets and FTSE Emerging Markets Global Bond Index). However, the timeline for the inclusion would be contingent upon the decisions by the index providers.

Given the issues mentioned in the above Section, the IDG feels that to strengthen the financial markets the issues related to KYC and registration requirements for FPIs need to be rationalised/simplified. There is also a need for undertaking the liberalisation of domestic financial markets in a phased manner. Further, to deepen the NDDC markets all AD Cat-I banks may be allowed to access the NDDC markets at par with IBUs. Similarly, the interbank market also needs to be strengthened by permitting AD Cat-I banks to trade in INR in the onshore and offshore markets in a phased manner, thus enabling continuous price discovery. A global 24X5 INR market needs to be strengthened by permitting interbank forex transactions through overseas branches and subsidiaries of AD Cat-I banks.

4.4 The Way Forward

Based on the detailed analysis in this chapter, the IDG has crystalised recommendations which would pave the way for a calibrated road map for internationalisation of INR. These recommendations are presented in the following chapter.

5 Reform measures and recommendations

There is nothing permanent except change.

- Heraclitus

उद्यमेन हि सिध्यन्ति, कार्याणि न मनोरथैः ।
न हि सुप्तस्य सिंहस्य, प्रविशन्ति मुखे मृगाः ॥

We can accomplish tasks only by making continuous strenuous efforts and not merely by wishing for results. By no means do antelopes enter the mouth of a sleeping lion.

- Hitopdesh

The IDG has deliberated all the issues in the Terms of Reference in a granular manner and recommends a set of time-bound steps, which would accelerate the pace of internationalisation of INR. The Group notes that some of these steps may have already been initiated, either internally or as a part of other Groups and some are currently work in progress. The Group recognises that the internationalisation of INR is a process rather than an event, and thus to enable, track and monitor the progress, certain milestones for implementation have been recommended. The timeframe of different recommendations is suggested depending upon the institutional capacity, preparedness and priority of macroeconomic supporting conditions.

After discussing the rationale for the need for further reforms in the previous chapters, the IDG recommends[30] the following measures for their implementation:

(I) Short Term Goals: Timeline for implementation: up to 2 years

1. **Standardised approach for Central Bank (INR/FCY) swaps and multilateral/bilateral trade arrangements:** In the recent past, RBI has been receiving a large number of proposals from various jurisdictions for multilateral/bilateral swaps and trade arrangements in local currencies. These are being examined separately by various departments, in consultation with the Government. A standardised approach/uniform template, which was recently prepared by DEIO (as detailed in **Annex 5.1**), is recommended for adoption. This

[30] Some suggestions have been taken by the IDG from the recommendations of the Task Force on offshore Rupee markets headed by Ms. Usha Thorat. The recommendations in the IDG report at points 10, 13 and 14 are based on the recommendations of the Task Force. The IDG feels that these recommendations need to be implemented for furthering internationalisation of INR.

uniform template may be used for examining all proposals that involve bilateral and multilateral trade agreements/arrangements for invoicing, settlement and payment in INR and local currencies of counterpart countries, local currency settlement mechanisms and bilateral swaps. The objective of this uniform template/standardised approach is to primarily identify the terms of trade with the counterpart country/ies (to understand which country will accumulate balances in the other's currency and how the surplus could be gainfully deployed to the mutual benefit of participating countries). Such a template will help in deciding on such a swap arrangement and ensure consistency in dealing with such proposals from various countries **(Para 4.2.1)**.

2. **Leverage on existing bilateral and multilateral currency settlement systems**: We may use existing bilateral and multilateral payment and settlement mechanisms, such as ACU, to internationalise INR by encouraging/ enabling its usage as an additional settlement currency in these mechanisms. The Bank may pursue the same to implement a mechanism to have INR as an additional settlement currency in the ACU **(Para 4.1.1)**.

3. **Facilitating and encouraging Local Currency Settlement (LCS) and implementation of a liquidity framework for the same:** The IDG recommends that the LCS framework may be examined after analysing the terms of trade with the counterpart country/ies with the provision of adequate INR liquidity in both international and domestic banking sectors **(Para 4.2.1)**.

4. **Operationalising Swaps in Local Currencies (LCYs):** As elaborated in **para 4.2.1,** there is an increasing role of bilateral swap arrangements in the internationalisation of INR, hence the IDG recommends the following approach for handling the challenges of operationalising bilateral swap arrangements with the counterpart countries in LCYs:

   (i) The challenge of exploring avenues for investments of surplus LCYs needs to be addressed based on the mutual consent of both countries. The alternatives that may be examined may include investments of surplus in LCYs as FDI, FPI, sovereign and corporate debt, infrastructural projects, and interest-bearing deposits, among other options.

   (ii) The exchange rate for conversion of currencies may be arrived at with reference to a third currency like USD, to begin with. However, it is expected that over a period of time, market development in LCYs will obviate this need to use a third currency.

   (iii) Alternative messaging (*e.g.*, SFMS), cross-border payments and the use of national payment systems like RTGS, NEFT and UPI may be considered to reduce transaction costs and other challenges. The usage of these systems may be explored by expanding its access/participation of non-residents and other jurisdictions.

   (iv) Indian commercial banks need to be encouraged to enter into correspondent banking relationships in INR and domestic currencies of counterparty jurisdictions.

5. **Opening of INR Accounts by non-residents:** The ability to open accounts outside the country of the currency is a foundational element of the internationalisation of a currency. Initially, non-residents (other than banks) may be allowed to open INR accounts only with the overseas branches of Authorised Dealers

(ADs) to undertake current and capital account transactions permitted under the FEMA, 1999. At a later stage, based on the experience of implementation and readiness of the system, permitting the opening of an INR account with any overseas bank and without any restrictions in terms of purpose, including for transactions between two non-residents, may be considered. Further, a single SNRR account may be allowed to be used by non-residents for all permissible capital and current account transactions. **(Para 4.1.2)**.

6. **Expanding the footprint of highly successful INR-based payment systems:** The availability of a robust 'INR denominated payment mechanism' providing timely settlements and inter-bank transfers would also be an important step towards internationalisation of INR. The Bank may implement payment mechanisms akin to UPI-PayNow integrated payment system with the partner countries, as another mode of settling cross-border INR/LCY denominated transactions under the present frameworks **(Para 4.2.4).**

7. **Strengthening financial markets:** Historical experiences show that a well developed financial market is a key element for the use of a currency as an international vehicle currency. While many steps have alreadybeen taken in this direction, the Group recommends that the following steps may be considered further.

    a) **Move towards a global 24x5 INR market:** To foster a global 24x5 INR market, it is suggested that AD Cat-I banks may be permitted to undertake interbank forex transactions through their overseas branches and subsidiaries. Similarly, market-makers in the interest rate derivative market may also be allowed to undertake customer and inter-bank transactions on a 24x5 basis through their overseas branches and subsidiaries. As a complementary measure, the possibility of extending the operational hours of CCIL-operated trading platforms, *viz*., FX-CLEAR, FX-SWAP and ASTROID, to enable overseas branches and subsidiaries to continuously discover prices and provide liquidity, could also be examined **(Para 4.3.4).**

    b) **Integration of onshore and offshore forex markets:** AD Cat-I banks with an operational IFSC Banking Unit (IBU) have been allowed to deal with INR non-deliverable forex derivatives. One of the primary objectives of this measure is to remove the segmentation between onshore and offshore markets and improve the efficiency of price discovery. There is merit in permitting all AD Cat -I banks to deal with such derivatives to achieve efficient integration of the markets **(Para 4.3.2).**

    c) **Promoting India as the hub of INR transactions and main centre for INR price discovery:** Allowing participants to freely access the onshore forex derivative market without the need for underlying exposure may help in further enhancing liquidity in the onshore market and thereby promoting it as the main centre of INR price discovery. It is recommended that, in the first phase, resident users may be allowed to undertake non-deliverable INR forex derivatives without any restrictions in terms of purpose, bringing them at par with non-resident users. In subsequent phases, users (both resident and non-resident) may be allowed to access the exchange-traded and the deliverable forex derivative markets without any restriction in terms of purpose **(Para 4.3.3).**

    d) **Launch of BISIP- INR:** The Bank may pursue the early launch of a BISIP-INR with the BIS. This will help further the internationalisation of INR and also facilitate the inclusion of INR in the SDR basket **(Para 4.3.5).**

    e) **Inclusion of Indian Government Bonds in global bond indices:** The Bank may step up measures to engage with index providers for the inclusion of IGBs in global bond indices **(Para 4.3.6).**

8. **Recalibrating the FPI regime:** There is a need to optimise and rationalise the FPI regimes to facilitate a more conducive environment for foreign investments into the Indian debt markets (both Government and Corporate). It is recommended that all G-secs may be included under the Fully Accessible Route (FAR). As regards corporate bonds, investment limits under VRR may be set inpercentage terms and reviewed annually, like the MTF, and the MTF may be rationalised by removing the short-term limit and the concentration limit while retaining the other macroprudential controls **(Para 4.1.4).**

9. **Equal treatment to exporters invoicing and settling in INR:** Exporters are incentivised as they earn foreign exchange. However, Government may consider extending the same benefits/incentives to exporters who choose to settle their transactions in INR vis-à-vis those who settle their transactions in freely convertible currencies. **(Para 4.1.1).**

10. **Harmonising of KYC Requirements:** One of the operational issues reported by international investors is the extant KYC requirements. The IDG recommendsa review of the extant KYC guidelines for rationalising the KYC requirements of FPIs to ensure ease of participation of non-residents (reduction in transaction and compliance costs) in the domestic financial markets **(Para 4.3.1).**

(II) Medium Term Goals: Timeline for implementation: 2 to 5 years

11. **Masala bonds framework liberalisation:** Waiver of the withholding tax for Masala bond issuances will reduce the cost of issuance and thereby the cost of capital. This may be examined by the concerned authorities **(Para 4.1.1).**

12. **Expanding RTGS system for settling international transactions:** Use of RTGS for international/cross-border transactions may be explored. Further, expanding the use of UPI for cross-border settlements, which is currently limited to certain individuals (travellers) and up to a certain amount may be examined. This may also require certain exemptions from extant documentation requirements under FEMA as instant/real-time settlement will take place. NPCI may provide aggregate import/export figures for such transactions to take care of the data requirements for BoP compilation **(Para 4.2.4).**

13. **Inclusion of INR in Continuous Linked Settlement (CLS) system:** INR may also be included as a direct settlement currency in CLS. The process of including a currency in CLS may take two to three years, as CLS does a thorough analysis of the legal aspects of clearing and settlement in the country. The inclusion of INR as a currency in CLS will bring visibility to the INR. The benefits therefrom could scale up INR usage, depending on willing countries using the platform for the purchase of INR against their currencies. The clearing system would provide its member banks with a market to purchase currencies against their domestic currency. This may in the long-term enable the creation of an Indian Clearing System. As a related recommendation of the Usha Thorat Task Force on Offshore Rupee markets, it was recommended that for ease of entering into hedge transactions for non-residents, a central clearing and settlement mechanism for non-residents' deals in the onshore market may be established. The IDG also recommends the same. The challenges posed by the regulatory guidelines under each of the jurisdictions may need to be suitably addressed **(Paras 4.2.5 and 4.2.6)**.

14. **Resolving Taxation issues:** Another barrier to free investments in Indian markets is the taxation issue. The IDG recommends that the government may examine the issue of taxation in financial markets to overcome gaps between tax regimes in India and other major international financial centres (*viz*., Singapore, Hong Kong and London, *etc*.), to the extent possible, thereby incentivising non-residents to participate in the onshore market **(Para 4.3.3).**

15. **Banking Services in INR through offshore branches of Indian banks -** To increase the share of INR in international markets by enhancing its usage in invoicing of bills related to trade and services and settlement of financial market transactions, Indian banks may provide banking services (loans, guarantees, credit lines, *etc*.) in INR in offshore markets. Indian banks are permitted to open offices abroad by RBI, however, these offices are bound to the laws and regulatory requirements of the host country. Thus, business activities undertaken by the offshore branches of Indian banks are subject to host country regulations. Though, there seems to be no explicit restriction in terms of offshore branches of Indian banks providing banking services and participating in financial markets in INR, the guidelines issued till now have not taken into account the aspect of banking business in INR through offshore branches of Indian banks. Accordingly, there is a need to revisit the existing regulations in this context and make necessary changes, as may be required. **(Para 4.1.3)**

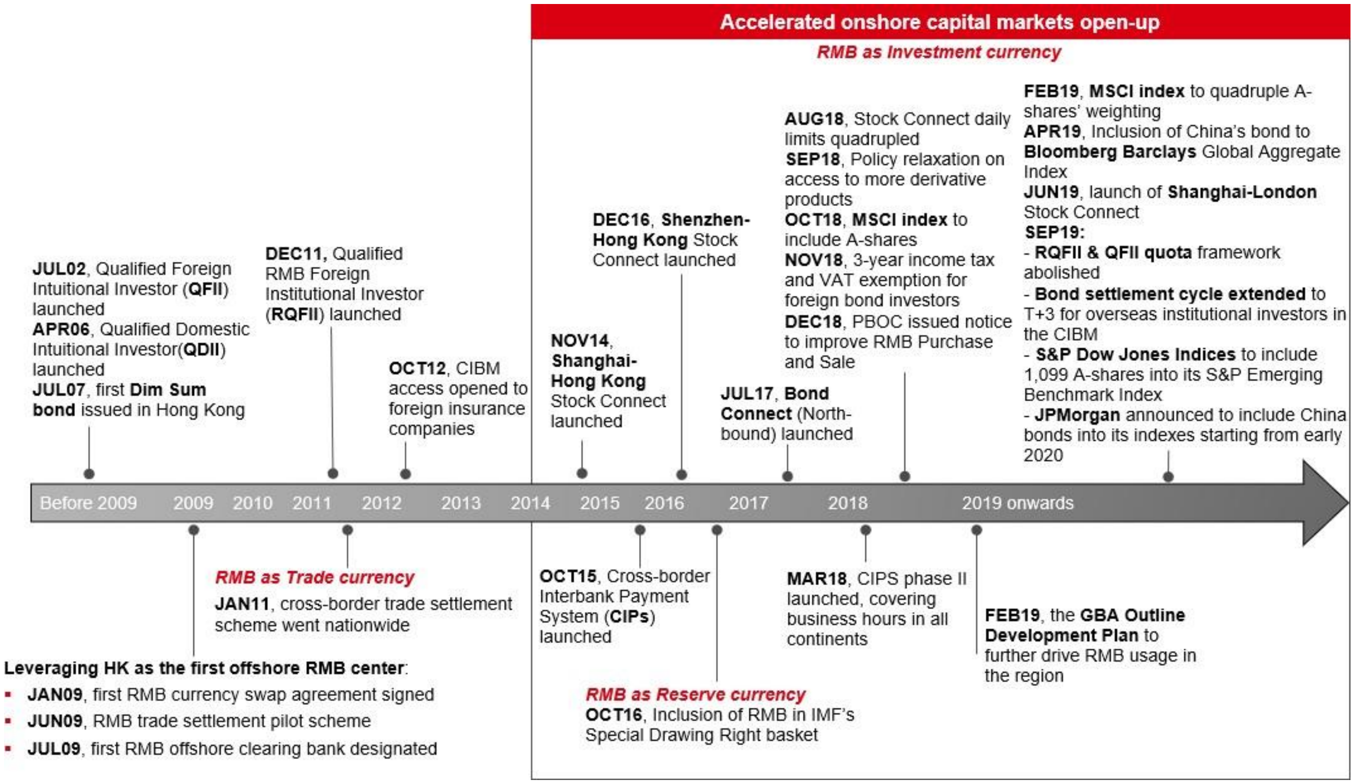
(III) Long Term Goal: Timeline for implementation: 5 years and above

16. **Inclusion of INR in SDR basket** – In the process of attaining the objective of INR as a “Vehicle Currency”, the Bank may target the inclusion of the INR in the SDR basket **(Para 4.2.7).**

Annexures

Annex 2.1

Chart A2.1: RMB's journey as an international trade, investment and reserve currency



Why is China focused on Renminbi internationalisation?

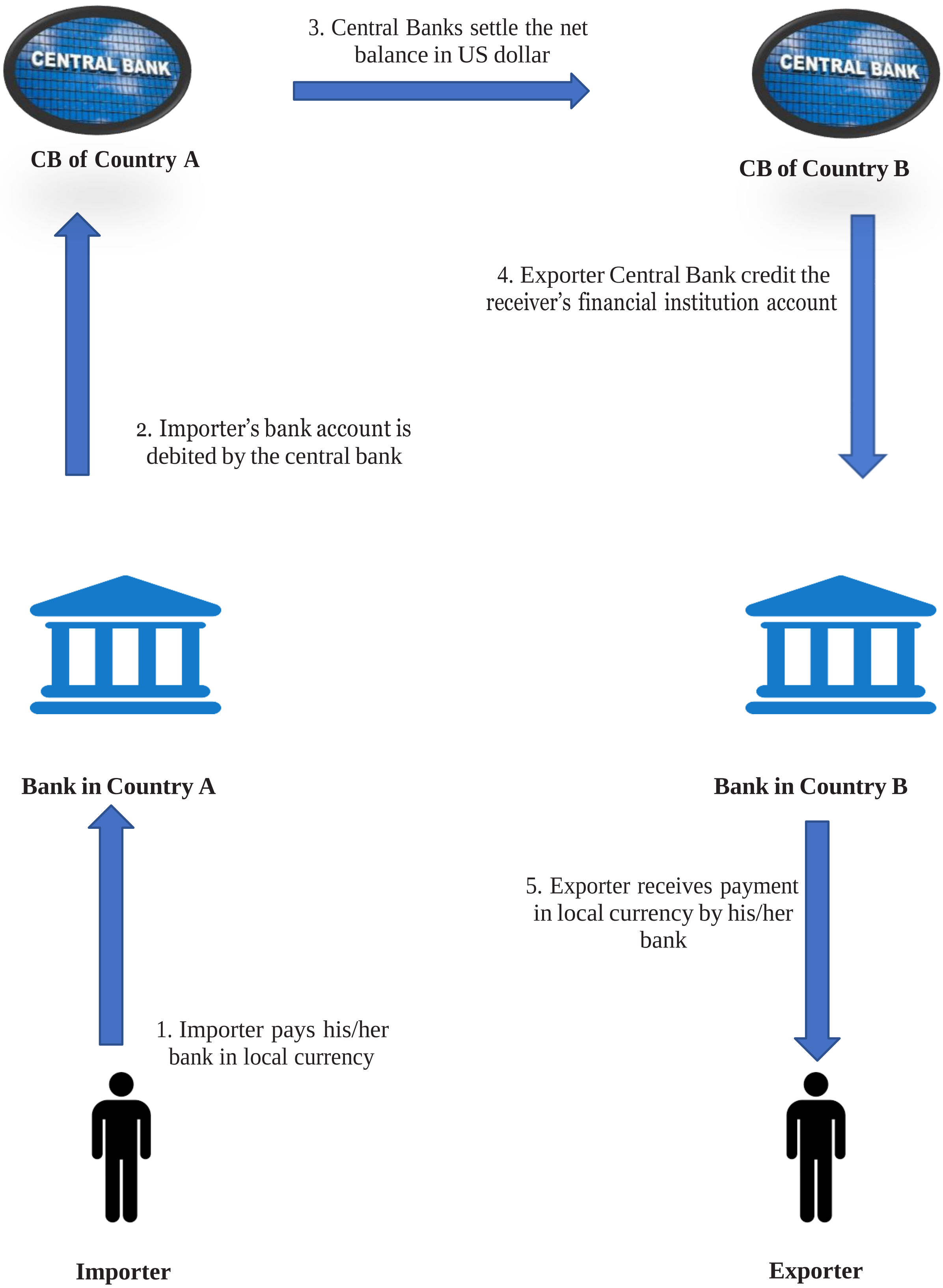
Pursuing the Renminbi's internationalisation is of evident benefit to China, both from a political and economic standpoint. The importance further grew on the back of the growing need to counter the dollar trap and extend Beijing's global influence. The Chinese Renminbi is making deeper inroads as a currency of choice for global payments. This would enable the currency to have certain benefits like:

- Reduction of exchange rate risks to which Chinese firms are exposed;
- Greater funding cost-effectiveness for Chinese financial institutions, thus strengthening their competitiveness in global financial markets;
- A boost to China's trade with its neighbours, owing to the reduction in transaction costs;
- Less need for China to hold US dollar assets and risk capital losses on the country's foreign exchange reserves;
- Eventual status as one of the world's major reserve currencies would give China more freedom to manoeuvre domestic and international markets.

In pursuance of its goal of securing increased Renminbi use internationally, China launched the offshore Renminbi (CNH) in 2009 and signed currency swap agreements with numerous countries. However, the need for capital control measures, limited Renminbi convertibility on the capital account and a not-yet mature financial sector are still major challenges ahead.

Annex 2.2

Chart A2.2: SML Operational Flow



Annex 2.3

Chart A2.3: COMESA REPSS Operational Flow

Annex 3.1

Details of the proposal for use of Domestic Currency in the ACU mechanism

Under the aegis of ACU, RBI floated a proposal of ***"Use of domestic currency in the ACU mechanism"*** considering the benefits that would accrue to the members given the relatively freer availability of domestic currencies, especially INR. The proposed mechanism may include the following:

Settlement Mechanism: A mechanism has to be developed in the ACU to calculate and advise daily cross-currency exchange rates. To encourage trade financing under the mechanism, enhancing swap arrangements and exploring Multilateral Currency Swap Arrangements may be considered. A settlement mechanism has to be set up to enable the settlement of accounts using an automated clearing system mapping end-to-end participants of the ACU mechanism. In case the bi-monthly settlement happens in freely convertible currency, then the methodology of converting debt denominated in local currency into freely convertible currency and the pricing of the debt needs to be formulated.

Trade Invoicing: As trade invoicing was a major catalyst in promoting the usage of local currencies, invoicing of trade in domestic currencies needs to be encouraged by facilitating a more liberal trade policy in each jurisdiction coupled with an enabling regulatory environment.

Regulatory aspects: To ensure a smooth flow of transactions from end-to-end, the group recommended that members may contemplate putting in place requisite approvals from the concerned authorities in their respective jurisdiction, *e.g.*, the exchange control authorities and the Government in each of the countries would need to bring in regulatory changes enabling one or more options for utilisation of possible accumulations in debtor countries. This will formally allow its currency to be used as a settlement currency for ACU transactions.

The utilisation of trade surplus: The usage of surplus currencies as a result of trade surplus has to be facilitated to enable the bi-monthly settlement in domestic currencies. It is recommended alternative avenues of investment arising from the trade surplus like investment in interest-bearing fixed deposits, FDI/FPI, including Government securities and high-rated corporate bonds and netting through invisibles, including tourism, among others.

Annex 3.2

RTGS built on SFMS Model

For any country with which we want to have a payment and settlement arrangement, the RTGS platform (with the multicurrency feature enabled in RTGS) can be leveraged. For this purpose, a new compartment within RTGS set up, say international RTGS (IRTGS), can be created. The banks in other countries will be offered IRTGS membership for transacting in respective international currencies and/or INR with other participating banks in the IRTGS ecosystem. The IRTGS can be used in two modules, *viz.,*

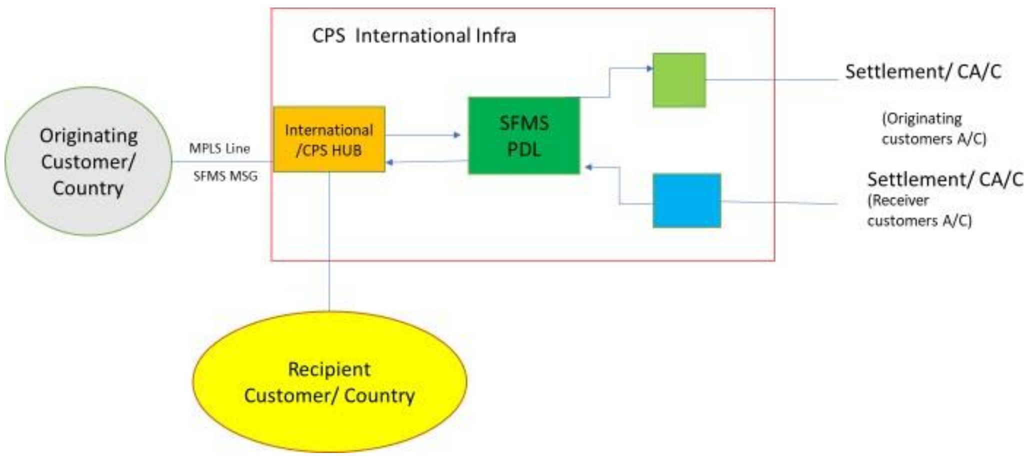
1. For the transactions internal to the country in the currency of the country.
2. For all cross-border transactions between countries in internationally accepted currencies, including INR.

To enable this, the international banks will be given direct or sub-membership (Sponsor bank model) depending upon the available infrastructure in that country. One bank in each country can be the nodal bank and other banks of that country can be its sub-members. The sub-member banks of other countries would use any available secured communication line to send SFMS messages to their nodal bank through the SFMS application provided to them. The nodal bank of each participating country would be extended Indian Financial Network (INFINET) membership, and they will, after requisite due diligence, push their and sub-member messages to IRTGS through an international Hub (say managed by Indian Financial Technology and Allied Services - IFTAS or Primary Data Centre) using INFINET. Each of the nodal banks will have a settlement account in RBI for internationally accepted currency/INR, while for other local currencies for national transactions each sub-member will have settlement accounts with nodal banks for which they will have their pledged currency deposits with nodal banks. It can be contemplated whether, for shortfalls, any liquidity support is to be extended. The bank of country A can through its nodal bank transact for a particular currency with a bank in country B (also a participant in IRTGS) for which payment and settlement will happen through the IRTGS. The settlement will be guaranteed through the nodal banks where sub-members would have pledged deposits/collaterals to avoid settlement risk. IRTGS can work as a platform for cross-border trade transaction settlements in INR and/or as a central platform offering multi-currency payment and settlement services for member banks from participating countries.

The detailed flow is depicted below:

Chart A3.2

RTGs built on SFMS Model for all currencies including INR



Annex 4.1

The present position of INR provisions under FEMA, 1999

INR accounts and deposits by non-residents

Non-residents can open various types of INR accounts in India as per their eligibility, *viz*., Special Non-Resident Rupee (SNRR) account, Non-Resident Ordinary Rupee (NRO) account and Non-Resident (External) Rupee (NRE) account. Further, they can also place INR deposits with banks in India. NRI/OCI card holders can additionally place deposits with a company or a proprietorship concern/firm. However, non-residents cannot open INR accounts overseas.

Trade

Trade invoicing in INR is permitted as there is no such restriction in the Foreign Exchange Management Act, 1999, and the rules, regulations and directions framed thereunder. As per Foreign Trade Policy (FTP) 2015-20, all export contracts and invoices shall be denominated either in freely convertible currency or INR but export proceeds shall be realised in freely convertible currency. Under FTP, export proceeds can be realised in INR if it is through a freely convertible vostro account of a non-resident bank situated in any country other than a member country of the Asian Clearing Union (ACU) or Nepal or Bhutan. Similarly, the payment for the imports can also be made in INR through a freely convertible vostro account for the countries outside ACU or Nepal or Bhutan. Export proceeds realised in Indian Rupees against exports to Iran are permitted to avail export benefits/ incentives under the FTP, at par with export proceeds realised in freely convertible currency.

AD banks in India have been permitted to open Rupee vostro accounts. For settlement of trade transactions in INR with any country, as an additional arrangement AD banks in India can open Special Rupee vostro accounts of correspondent bank/s of the trading partner country. Rupee payments for imports can be credited to these accounts. The funds in the Special vostro account can be used, *inter alia*, for making payments for exports from India. Accordingly, FTP has been recently amended as well to align with this provision.

Even though settlement in INR may be negligible, INR invoicing for trade transactions, where currency risk shifts to the non-resident, are reasonable. External Commercial Borrowings, Trade Credits and other borrowings

Eligible entities resident in India are permitted to raise overseas borrowings under the External Commercial Borrowings (ECB) framework subject to compliance with certain norms. Under the said ECB framework, raising of ECB is also permitted in INR*, i.e.*, through loan agreements, non-convertible and optionally convertible debentures and preference shares, trade credits beyond 3 years and financial lease. INR ECB can also be raised through marketable instruments (bonds) known as Rupee denominated bonds (Masala bonds). The masala bonds can be listed or privately placed overseas. The overarching ECB framework requires compliance to various parameters like minimum average maturity period, permitted end-uses, recognised lenders, eligible borrowers, all-in-cost ceiling, hedging requirements, *etc*. INR denominated ECBs, including Masala bonds, are provided witha liberal dispensation in some of these parameters, *e.g.,* not-for-profit entities engaged in micro-finance who are not eligible to raise FCY ECB can raise INR ECB or can refinance any FCY ECB to INR ECB under automatic route. Foreign branches of Indian banks, including those in IFSC, are not permitted to provide INR ECB.

Additionally, eligible resident entities, as defined by the Government of India, can borrow from overseas Multilateral Financial Institutions/International Development Financial Institutions, where the source of funds of such institutions is Rupee denominated bonds issued overseas or resources raised domestically. Trade credits for imports into India are also permitted to be raised in INR. However, a resident individual can borrow only in INR from NRI/Relatives who are OCI Cardholders outside India. SNRR accounts of non-residents in India can be used to lend ECB/trade credits in INR.

Inward FDI, FPI and other investments by a person resident outside India

In terms of INR usage, Foreign Portfolio Investors and Foreign Venture Capital Investors (FVCIs) are permitted to make portfolio investments in equity instruments of Indian companies on stock exchanges using SNRR account. Foreign portfolio investors can also make investments in units of investment vehicles and domestic mutual funds. FDI by FVCIs is also permitted through the SNRR account.

An NRI or OCI can use an NRE account to make repatriable investments, *viz*., FDI and portfolio investments and non-repatriable investments in Indian companies, limited liability partnership (LLP), firm or a proprietary concern and investments in Investment vehicles, Indian Depository Receipts and convertible notes.

An NRI or OCI can use an NRO account to make non-repatriable investments in equity instruments of an Indian company or units or contribution to the capital of a LLP and repatriable investments by subscription to the National Pension Scheme (NPS).

Lending in INR

For permitted purposes in India, an AD can grant a loan to an NRI/OCI Cardholder for meeting his/her requirements/ own business purposes/acquisition of residential accommodation in India/acquisition of motor vehicle in India/ or for any purpose as per the loan policy laid down by the Board of Directors of the AD. Further, a registered non-banking financial company in India or a registered housing finance institution in India can provide a housing loan or vehicle loan, as the case may be, to an NRI/OCI Cardholder. An Indian entity can lend in Indian Rupees to its employee who is an NRI/OCI Cardholder under its Staff Welfare Scheme. A resident individual can grant a Rupee loan to its NRI/OCI Cardholder relative within the overall limit under the Liberalised Remittance Scheme.

Annex 4.2

Swaps and Bilateral/Multilateral arrangements - Indian experience

The global network of bilateral swap lines (BSLs) expanded dramatically over the past decade. The expansion started during the Global Financial Crisis (GFC), as the Fed renewed the BSLs with the five major central banks in 2010 and converted them into permanent standing facilities in 2013, while allowing BSLs with other Advanced Economies (AE) and EM central banks to expire as market conditions improved. During this period, China also started to expand its BSL network in a bid to promote the internationalisation of the Renminbi and facilitate trade and investment. Further, the European Central Bank agreed in Oct 2013 to establish a swap network with the People's Bank of China (PBoC). Under this agreement, it extended Euros worth about USD 50 billion to the PBoC, while the PBoC extended the same amount to the European Central Bank in its currency, the Renminbi. As a result, the number of BSLs increased from only a few in 2007 to 74 as of end-2019. Since the onset of the COVID-19 pandemic, the global BSL network has grown further, reaching 91 at the end-2020, with the US Fed (once again) extending temporary BSLs to nine AEs and EMs.

India - extant status of bilateral/multilateral swap/LoC/liquidity arrangements

India too has entered into various bilateral/multilateral trade/payments arrangements with various countries to support liquidity arrangements in times of financial crunch. Some of the existing frameworks are discussed as under:

The Asian Clearing Union (ACU)

The Asian Clearing Union (ACU), started in 1974, is presently operating as a clearing and payment system among ACU members (Bangladesh, Bhutan, Iran, India, Maldives, Myanmar, Nepal, Pakistan and Sri Lanka) for the promotion of trade among the participating countries. Though the ACU mechanism envisages the use of domestic currencies for trade settlements, due to operational convenience and usage, currently only the USD, Euro and Yen are eligible as currencies for payment and settlement on a multilateral net basis. Currently, the trade settlement with Sri Lanka has been permitted outside the ACU mechanism.

SAARC swaps

The SAARC Currency Swap Framework came into operation on November 15, 2012, to provide a backstop line of funding for short-term foreign exchange liquidity requirements or short-term balance of payments stress till longer-term arrangements are put in place. Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka are part of the SAARC grouping. Under the framework for 2019-22, to strengthen regional financial and economic cooperation, the Reserve Bank has agreed to offer an amount of USD 2 billion (withdrawable in US dollar, Euro or Indian Rupee). The Framework provides certain concessions for swap drawls in Indian Rupee. The Currency Swap Facility is available to all SAARC member countries, subject to their signing the bilateral swap agreements.

Central Bank of UAE

A Memorandum of Understanding was signed between the RBI and the Central Bank of UAE in February 2016 to consider entering into a currency swap agreement subject to the concurrence of the respective governments. Subsequently, a currency swap agreement between India and UAE was signed in December 2018.

Annex 4.3

Approach/solutions towards provisioning of INR liquidity

(i) All foreign entities (Except for Central Banks and Sovereign backed entities)

Approach	Negotiated lines of INR liquidity from Indian commercial banks to foreign entities could be established for a suitable period (beyond intra-day) based on their risk perception, to encourage their participation in INR-based clearing and settlement.
Concerns	Domestic banks may not be inclined to take such credit exposure.
Recommended solutions	1. RBI may encourage domestic commercial banks to establish negotiated lines of credit for clearing purposes. Some relaxation in provisioning/risk weight may be permitted by RBI to encourage them to establish such negotiated lines of credit. 2. In case of further requirements of funds, these foreign entities can also arrange funds through arrangements with major domestic commercial banks (by paying commitment fees or any other suitable arrangements). 3. Alternatively, the financial institutions may get INR liquidity through their central banks who may, in turn, get INR funding through bilateral/multilateral swaps. 4. Going forward, a repo facility in INR on the lines of LAF may be explored for foreign central banks.

Overseas INR liquidity to offshore Indian banking institutions should be provided by their onshore parent, which will help the Reserve Bank keep its balance sheet protected to an extent and only act as a lender of last resort, whenever required.

(ii) Central Banks and Sovereign-backed entities

Approach	RBI could be the provider of liquidity for an extended period (beyond overnight) through bilateral/multilateral swap arrangements with foreign central banks/sovereign backed entities. Going forward, a scheme similar to LAF may be explored for these foreign central banks/sovereign backed entities based on evolving market conditions.
Concerns	The RBI liquidity support for INR internationalisation should be of modest amounts so that it does not impede the public policy objectives of low and stable inflation with desired growth.
Recommended solutions	The RBI may get into a swap arrangement with those central banks. As the lender of last resort, a) RBI can formulate a scheme akin to the LAF facility which is currently extended to participating banks. Under this scheme, the other central banks and Sovereign-backed entities, that have investments in G-secs may be allowed fixed rate repo and fixed rate reverse repo/standing deposit facility for an extended period. This design would also help minimise the risk on the balance sheet of the Bank. This will be in addition to the other avenues for the deployment of surplus funds. b) These central banks and sovereign-backed entities, which avail INR liquidity from the RBI, can be allowed to act as clearing agents for the entities under their jurisdiction. For uniformity, liquidity support to foreign central banks can be provided on similar terms as the domestic LAF participants.

Annex 4.4

Process flow for UPI [P2P and P2M(QR)] and RuPay (P2M POS)

The Reserve Bank of India and the Monetary Authority of Singapore (MAS) have announced a project to link their fast payment systems, UPI and PayNow. The linkage will enable users of the two systems to make instant fund transfers (remittances) without the need to get onboarded onto the other system. In other words, a userof UPI does not require to be a part of the PayNow system to be able to transfer funds to a PayNow user in Singapore and *vice versa*. The linkage builds upon the earlier efforts of NPCI International Payments Limited(NIPL, a subsidiary of NPCI) and Network for Electronic Transfers (NETS of Singapore) to facilitate QR code-basedpayments through UPI in Singapore. The initiative is in line with the Reserve Bank's vision of reviewing inbound remittance corridors between India and other countries.

The UPI-PayNow linkage can foster cross-border interoperability of payments and provide impetus to retail payments during travel and remittance flows in domestic currencies between the two countries. Singapore has a large number of Indian workers and students, resulting in substantial (more than USD 1 billion) in-bound and out-bound remittances every year. The UPI-PayNow linkage is expected to be a significant milestone in the development of infrastructure for cross-border payments between India and Singapore and aligns with the G20's financial inclusion priority of enabling faster, cheaper and more transparent cross-border payments. It can also contribute to fulfilling United Nations (UN) Sustainable Development Goals (SDG 10.c) by reducing the cost of remittances.

Understanding the UPI-PayNow system: The present settlements are through nostro/vostro accounts between two banks – one each on India and Singapore side. There would not be any change in it with the operationalisation of the linkage.

The benefits that the linkage will bring would not be about the settlement aspect but on others, such as ease, speed, and cost of transactions:

i. Ease of performing the transaction, as it would be executed through Virtual Payment Address (VPA)/mobile number/national id without a need to get onboarded onto the other payment system.

ii. Near real-time payments, as against the present settlement period of at least one working day.

iii. Enhanced transparency, as the applicable foreign exchange rates and charges shall be visible before confirming the transaction.

iv. Lower cost of transaction due to reduced time of payment and settlement, resulting in lower markup by the participating banks.

Detailed discussions with NPCI revealed that the current UPI system can be upgraded to include all types of transactions. The benefits accruing from the real-time payments feature of UPI and the low cost of UPI transactions can prove to be attractive for personal and retail transactions and a game changer for cross-border remittances. The UPI-based payment system can be implemented in its existing form with enhancements, and tie-ups between banks across borders for retail segments, remittances and foreign travel can be instituted. Trade and other related international transactions, apart from the upgrade of the UPI system, will also require certain additions in the processes by the banking industry and examination of reporting and regulatory compliance requirements. For this, close collaboration between the RBI, NPCI and the banking industry would be required.

Annex 4.5

A broad outline of the proposed framework of Indian Clearing System (ICS)

(i) A Special Purpose Entity (SPE) may be created with shareholding from all interested central banks. The SPE could be based in India.

(ii) All AD banks from these countries may be members of the SPE and hold multi-currency accounts.

(iii) SPE shall hold domestic currency accounts in participating central banks.

(iv) AD banks will approach the SPE for the purchase and sale of currency. The SPE will order match and put through the transaction on a gross basis by debit and credit to respective accounts. The accounts shall be settled through multilateral netting and member banks shall fund the accounts accordingly. The multicurrency account may be pre-funded and an overall positive balance should be maintained throughout the transaction cycle.

(v) The clearing system can also be linked to RTGS of the member countries to swap in/swap out the local currency from the accounts maintained at their central banks as per the transactions of the day.

The member banks and the SPE may be provided liquidity support through bilateral/multilateral swap agreements.

Benefits accruing from such a system

(i) It will provide a marketplace for the purchase and sale of currencies which are hitherto difficult/expensive to obtain (currencies that are not freely convertible).

(ii) It will enable the development of a vibrant forex market in such currencies. Initially, the forex rates could be cross-rates, and encouraged to be market-determined over time.

(iii) It will bring efficiency to the settlement in domestic currencies.

(iv) It will reduce the cost of depending on a correspondent banking network.

(v) Reduced liquidity requirements on account of the netting of transactions at the AD banks level.

Approach towards creating an ICS

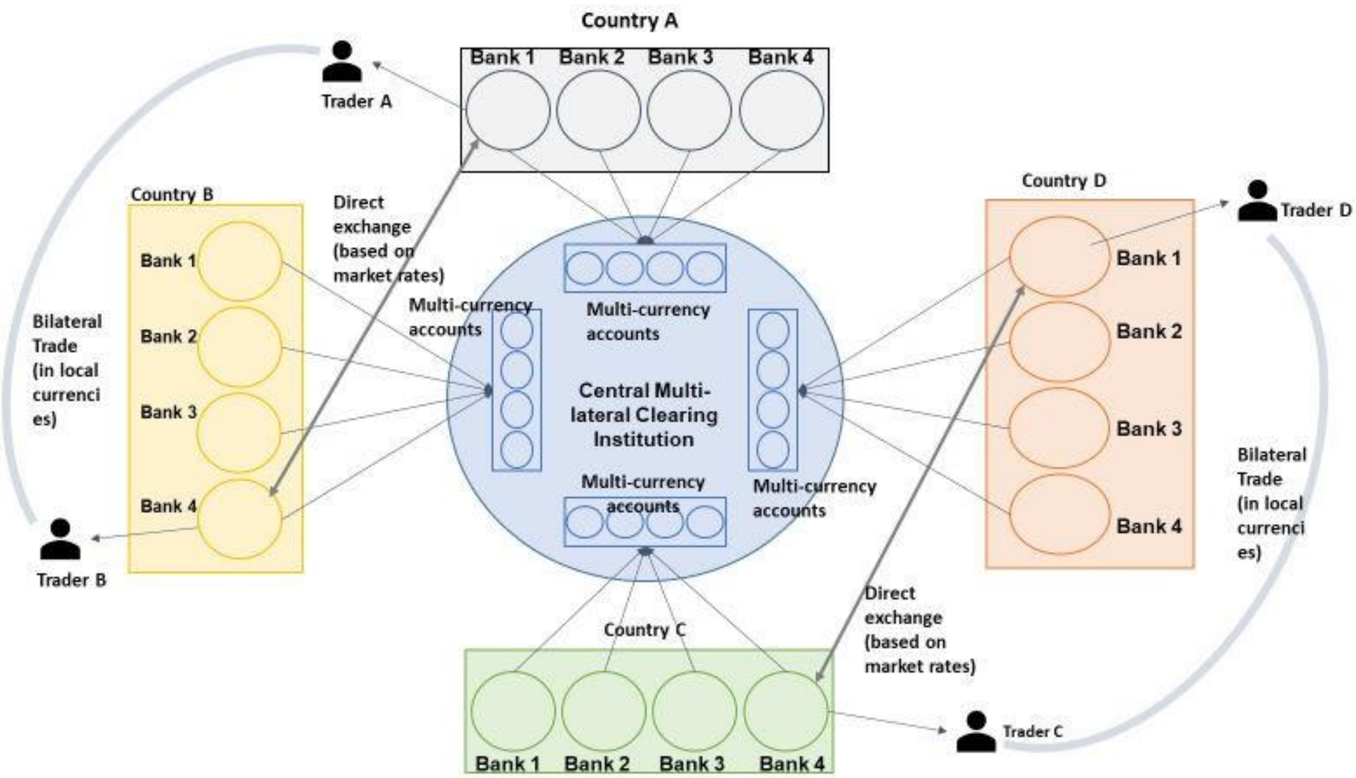
Initially, ICS can be implemented in bilateral/multilateral settlement arrangements and then scaled up to include willing countries.

Near Term Recommendation – Enable UPI for retail segments, remittances and foreign travel.

Medium Term Recommendation – Enable UPI for trade and related transactions. Swift messaging shall continue and may be also used for domestic currency transactions.

Long Term Recommendation – Develop an Indian Clearing system that provides for multi-currency settlement for countries using domestic currencies for trade and other transactions.

A pictorial representation of the same is as follows:

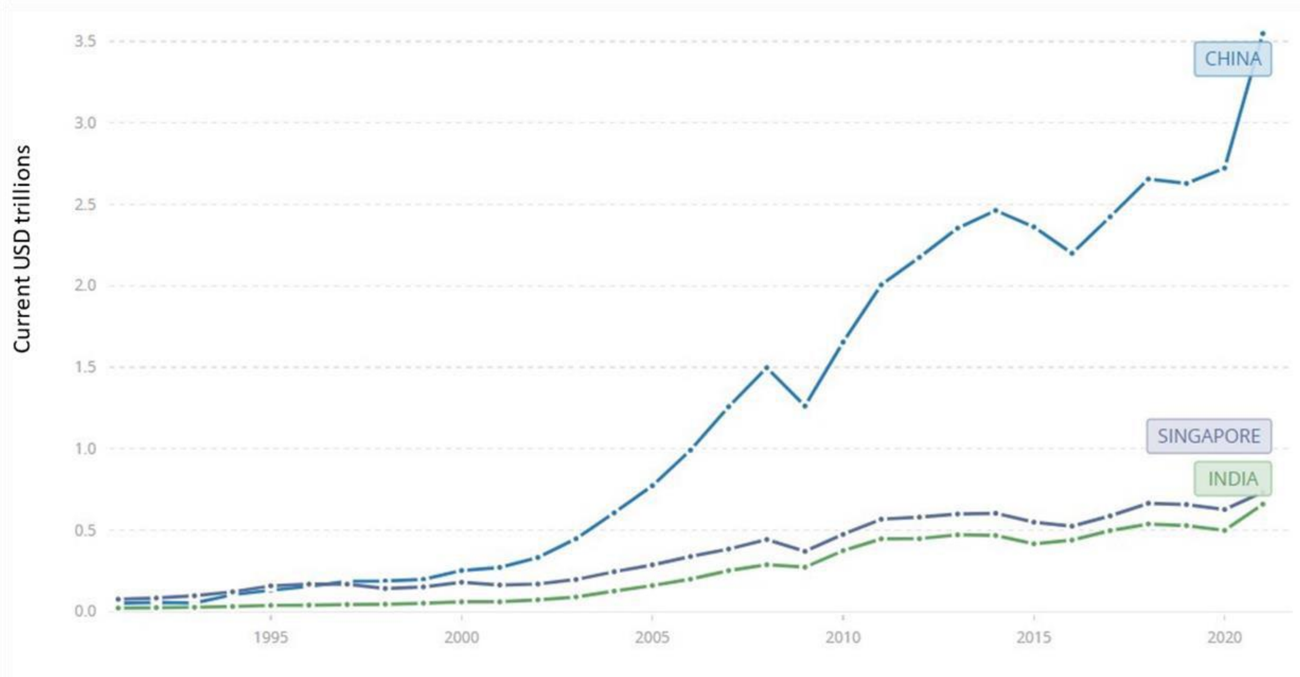


Annex 4.6

Inclusion of INR in the SDR basket - a long-term agenda

The current system of composition and weighting of the SDR currency market needs to be reformed for better outcomes and a stable SDR. In this regard, to consider the possibility of inclusion of INR in the SDR basket by examining the currency inclusion criteria, a review of India's position regarding the level of exports *vis-à-vis* other major exporters is necessary (Chart A4.3 below).

Chart A4.3



Source: World Bank

India's share of export of goods and services ranks reasonable when compared to the qualifying criteria and given the current thrust and vision, we will be qualifying in these criteria very soon. The IMF lists the position of currency in official reserves as an indicator of use by public authorities, and the sum of international bank liabilities (IBL) and international debt securities (IDS) as an indicator of currency used in private international finance transactions. The INR has gained prominence over the years, particularly since 2010. In terms of the overall ranking across currencies with respect to the over-the-counter (OTC) foreign exchange turnover, the INR was ranked at 16 in 2019, higher than 18 in 2016. In growth terms, the INR has recorded a growth rate of 96.1 per cent in average daily OTC total foreign exchange turnover during 2016 - 2019.

Table A4.2. A Comparative Assessment of China and India in terms of Currency and Trade Indicators

Indicators	2016		2019		Growth (Percent)	
	RMB	INR	RMB	INR	RMB	INR
Daily Average OTC foreign exchange turnover (USD billion)	202.1	58.0	285.0	113.6	41.1	96.1
Share in Daily Average OTC foreign exchange turnover (Per cent)	4.0	1.1	4.3	1.7	–	–
Rank in Daily Average OTC foreign exchange turnover	8	18	8	16	–	–
Daily Average OTC foreign exchange turnover: *Spot Transactions*	68	19	97	30	42.6	57.9
Share in Official Foreign Exchange Reserves*	1.1	NA	2.6	NA	–	–
Performance in World Trade**						
Indicators	China	India	China	India	China	India
Total Trade (USD billion)	3685.6	626.2	6051.5	967.9	64.2	54.6
Share in World Trade (Per cent)	11.4	1.9	13.5	2.2	–	–

*: Data relate to 2017 and 2021; **: The latest data relates to 2021.

Source: BIS' Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Markets in 2019; Currency Composition of Official Foreign Exchange Reserves (COFER), International Financial Statistics (IFS), IMF; and United Nations Conference on Trade and Development (UNCTAD).

Annex 4.7

Integration of onshore and offshore markets

The Reserve Bank has been engaged in developing a deep and liquid onshore foreign exchange market. Recognising the existence of bidirectional price linkages between onshore and offshore rates, the possibility of volatility spillovers from offshore markets, and segmentation between onshore and offshore markets impairing the efficiency of price discovery and undermining the regulatory framework, recent regulatory efforts have focused on improving access to the onshore markets by residents and non-residents while facilitating product innovation. On May 8, 2020, the two IFSC Exchanges, India International Exchange Limited (India INX)[32] and NSE IFSC Limited (NSE IFSC)[33], launched INR derivative contracts. Banks in India which operate IFSC Banking Units (IBUs) were permitted to participate in the NDF markets with effect from June 1, 2020. Fourteen Indian banks have started participating in the INR NDF markets since then. The daily turnover of these banks has steadily increased from less than USD 1 billion in the initial days to about USD4 billion in the recent period[34].

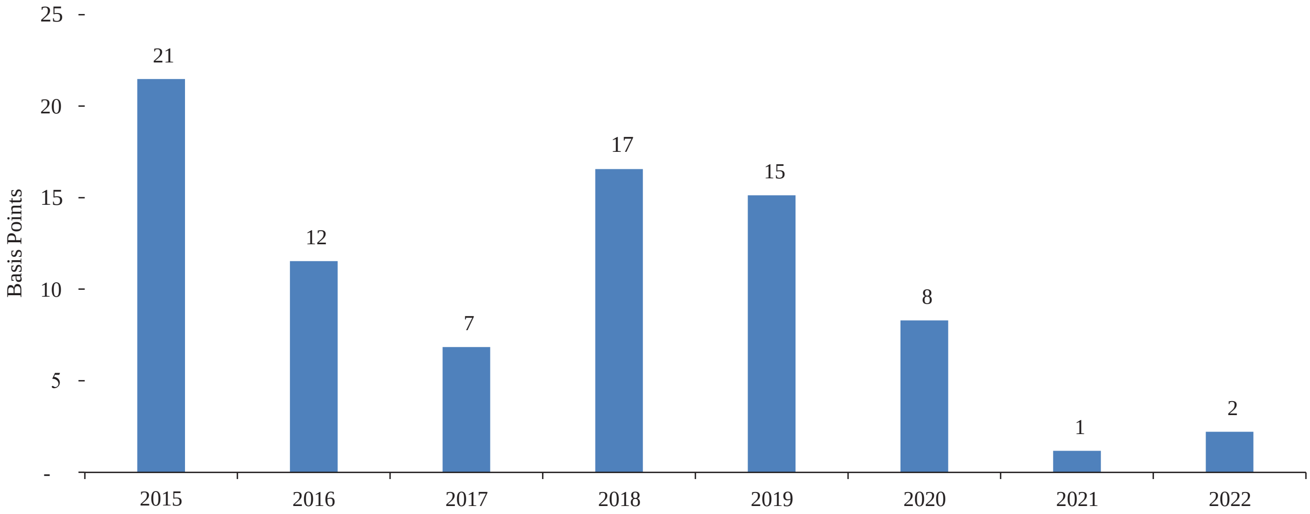
The participation of Indian banks in the NDF market appears to have positively impacted the price differential between offshore and onshore rates. Similar to growth in offshore NDF markets, an active market for Rupee interest rate swaps (IRS) has been growing offshore, with the most popular instrument being the non-deliverable overnight indexed swaps (ND-OIS), similar to onshore Mumbai Interbank Offered Rate (MIBOR) referenced OIS contracts. Recognising that this has effectively segmented the Rupee interest rate swaps (IRS) market between the onshore and the offshore markets impeding efficient price discovery, and to develop a deeper onshore market, non-residents were permitted to access the onshore interest rate derivative market in 2019. Post this, the participation of non-residents has increased in the onshore markets and the segmentation between onshore and offshore markets has reduced. The average spread between onshore MIBOR OIS rates and ND-OIS rates has fallen from a range of 7-21 basis points to 1-2 basis points in 2021-22. To provide a further fillip to the interest rate derivative market in the country and improve the efficiency of price discovery, banks in India have been recently permitted to undertake transactions in the offshore Foreign Currency Settled Overnight Indexed Swap (FCS-OIS) market with non-residents and other market makers. Importantly, an onshore interbank market in non-deliverable derivatives is emerging wherein local banks transact with each other. The participation of Indian banks in the NDF/FCS-OIS market has increased avenues for interbank risk management and, going forward, could help bring down the hedging cost for customers as depicted in the Chart below.

[31] Subsidiary of Bombay Stock Exchange (BSE).

[32] Subsidiary of National Stock Exchange (NSE).

[33] Including back-to-back transactions between bank branches.

Chart A4.4: Narrowing spread between ND-OIS and Onshore OIS Rates (5Y Tenor)



Source: Bloomberg.

Annex 5.1

Standardised approach for bilateral and multilateral trade agreements/ arrangements for invoicing and payment in INR and domestic currencies of counterpart countries

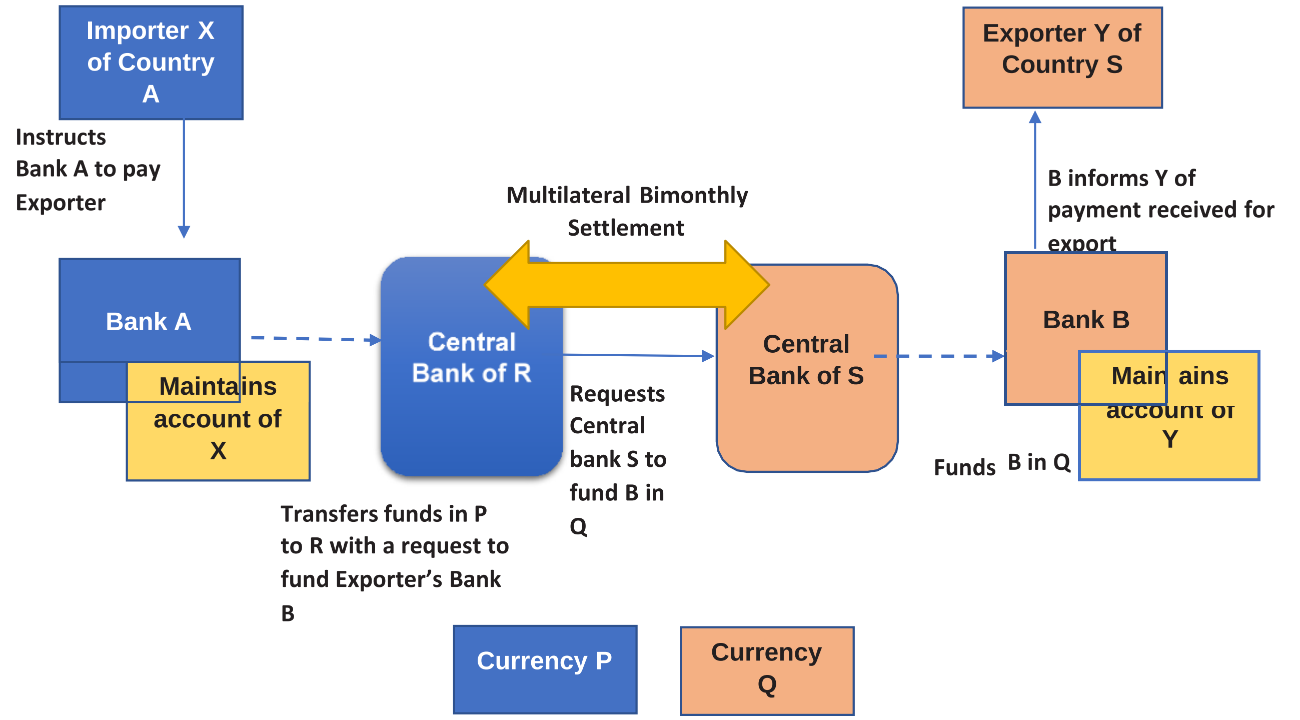
Identify the terms of trade with the counterpart country/ies – whether we have a trade surplus or deficit (this will ascertain which country will accumulate balances in the other's currency) and then look for how the surplus would be gainfully deployed to the mutual benefit of participating countries (data of trade balance is mentioned in Tables A5.1 and A5.2). Possible avenues are allowing usage of surplus funds for all permissible capital and current account transactions, including FDI, FPI, ECB and interest-bearing deposits.

1. Extending Lines of Credit (LoC), bilateral and/or multilateral swap arrangements between central banks in domestic currencies; and over a period of time consider allowing Indian commercial banks to extend LoCs/ credit facilities to non-residents in INR.
2. Allowing opening and usage of INR accounts to non-residents (banks and other entities, including individuals), both onshore (in India) as well as offshore with branches of Indian commercial banks abroad, as this will facilitate international trade transactions in INR.
3. Identifying a mechanism for working out (as far as possible market-determined and real-time) a daily exchange rate between the INR and other currency/ies through a third currency (say USD, *etc*.) for settling the transactions. The requirement and availability of hedging tools may also be examined for NRs who are exposed to currency risks owing to their open positions in INR.
4. Exploring the extension of Government incentives which are available for trade transactions in convertible currencies (Table A5.3) to the trade transactions being settled in local currencies.
5. Exploring the possibility of extending domestic payment systems/mechanisms such as UPI, NEFT and RTGS to the participating country/ies or integrating the existing payment systems of the participating countries (to enable seamless payments and receipt for cross-border trade transactions).
6. Exploring the feasibility of inclusion of local currencies in the Foreign Currency Assets (FCA)/Foreign Exchange Reserves (FER) in accordance with the IMF definition.
7. Enabling a mechanism for facilitating trade payments using commercial banks and central banks. A flow diagram (these are only indicative flow processes and can be modified on specific requirements) for the same is as follows:

Scheme 1 - Payments through Central Banks/designated commercial banks **without using correspondent banking channels**

(No need for a nostro – may reduce the cost of transactions). Creation of debtor-creditor relationship between participating central banks.

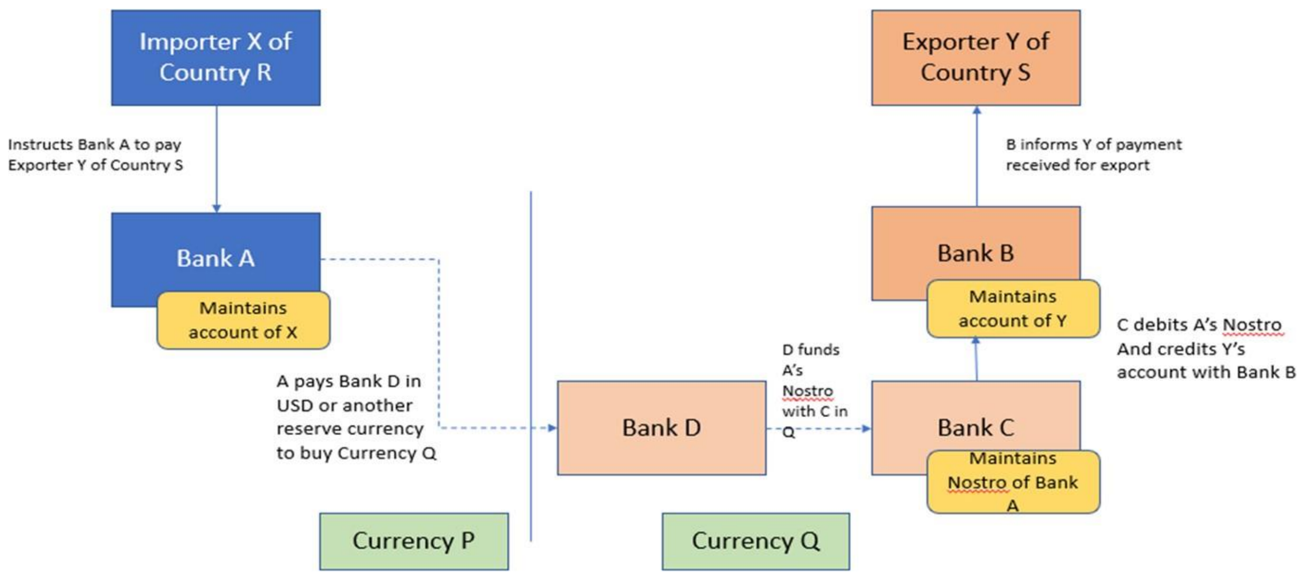
Chart A5.1


Importer X of Country A
Instructs Bank A to pay Exporter
Bank A
Maintains account of X
Transfers funds in P to R with a request to fund Exporter's Bank B
Central Bank of R
Multilateral Bimonthly Settlement
Requests Central bank S to fund B in Q
Central Bank of S
Funds B in Q
Bank B
Main ains account of Y
B informs Y of payment received for export
Exporter Y of Country S
Currency P
Currency Q

Scheme 2 - Payment through the **nostro accounts of commercial banks maintained in local currencies**

If the importer's bank does not have a surplus in its nostro account in the exporter's country, it can purchase domestic currency from a local commercial bank to fund its nostro account. **No involvement of Central Banks** in this case. In case there is a balance in its Nostro Bank A simply advises Bank C to pay Y's account in bank B.

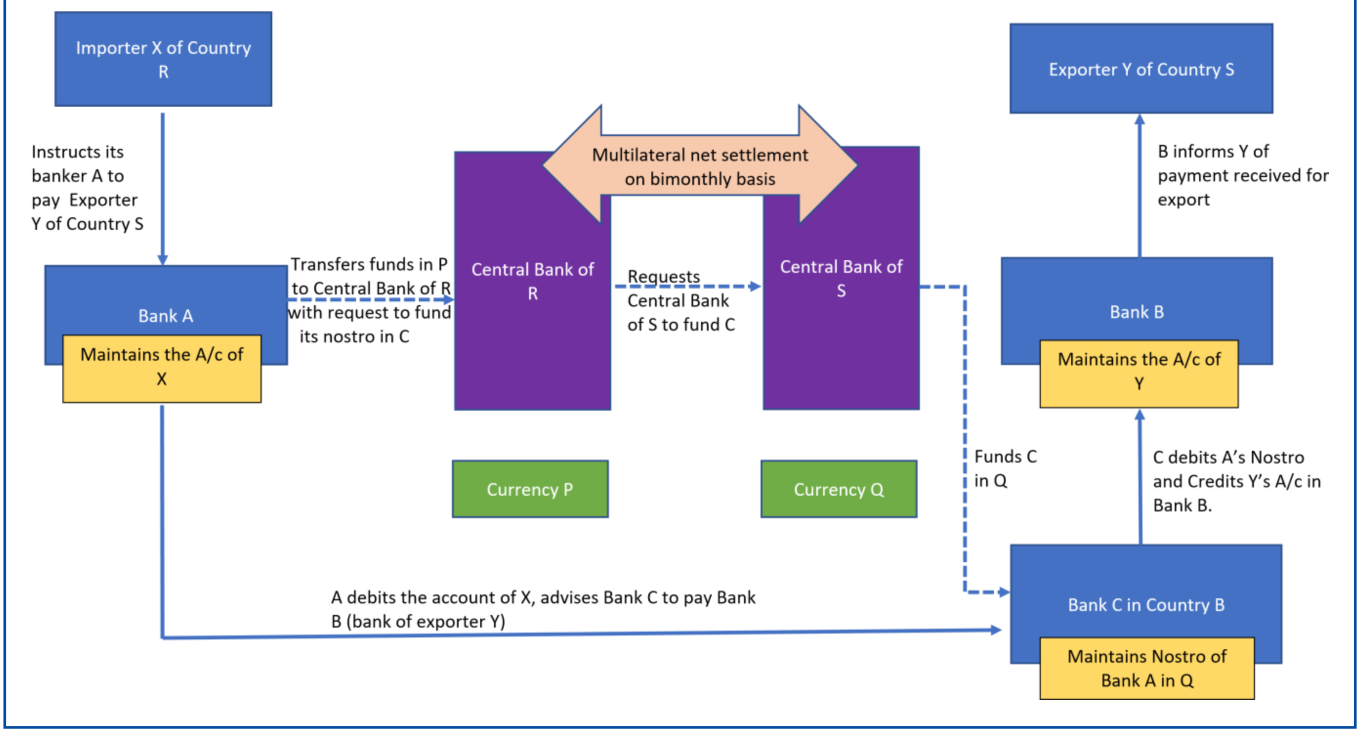
Chart A5.2



Scheme 3 – Payment through the **nostro accounts of commercial banks maintained in local currencies**.

If the importer's bank does not have a surplus in its Nostro account in the exporter's country, it can **fund its Nostro through the Central Bank**. (In case there is a balance in the nostro account, Bank A simply advises Bank C to pay Y's account in Bank B). There is a creation of a debtor-creditor relationship between the participating central banks.

Chart A5.3



Identification of the terms of trade with the counterpart country/ies – whether we have a trade surplus or deficit.

Table A5.1: Countries with which India has Trade Surplus > USD 500 million

Values in USD million

Rank	Country	2020-21	Rank	Country	2021-22
1	U S A	22,735.05	1	U S A	32,852.94
2	Bangladesh	8,599.90	2	Bangladesh	14,178.44
3	Nepal	6,165.30	3	Nepal	8,274.70
4	U K	3,201.80	4	Netherlands	8,065.59
5	Netherlands	3,155.10	5	Turkey	6,719.39
6	Sri Lanka	2,855.28	6	Sri Lanka	4,792.21
7	Turkey	2,485.56	7	U K	3,443.51
8	Kenya	1,765.57	8	Italy	3,132.29
9	Spain	1,726.60	9	Spain	2,672.45
10	Iran	1,443.20	10	Togo	2,635.23
11	Togo	1,247.00	11	Kenya	2,486.54
12	Brazil	1,228.95	12	Israel	1,722.34
13	Poland	946.32	13	Poland	1,599.15
14	Philippines	884.82	14	Philippines	1,378.12
15	Italy	873.69	15	Unspecified	1,253.78
16	Yemen Republic	762.15	16	Portugal	1,027.27
17	Israel	741.3	17	Iran	987.7
18	Portugal	723.18	18	Sudan	948.1
19	Unspecified	676.89	19	France	858.81
20	Sudan	654.05	20	Greece	777.5
21	Ethiopia	651.68	21	Brazil	775.69
22	Uganda	631.72	22	Somalia	726.52
23	Mozambique	599.74	23	Djibouti	671.66
24	Somalia	548.78	24	Mauritius	642.98
25	Tanzania Rep	504.18	25	Canada	631.21
			26	Ethiopia	618.84
			27	Yemen Republic	618.76
			28	Maldives	601.47
			29	Uganda	555.45
			30	Congo	536.97
			31	Guatemala	531.05
			32	Pakistan	511.29

Source: https://tradestat.commerce.gov.in

Table A5.2: Countries with which India has Trade Deficit >USD 500 million

Values in USD million

Rank	Country	2020-21	Rank	Country	2021-22
1	China	-44,025.10	1	China	-73,310.78
2	Switzerland	-16,969.43	2	Iraq	-29,523.78
3	Iraq	-12,788.12	3	Saudi Arabia	-25,341.64
4	Saudi Arabia	-10,330.15	4	Switzerland	-22,043.76
5	U A E	-9,943.45	5	U A E	-16,788.60
6	South Korea	-8,088.35	6	Qatar	-11,355.95
7	Indonesia	-7,443.95	7	Kuwait	-9,759.83
8	Qatar	-6,645.33	8	South Korea	-9,392.17
9	Japan	-6,490.15	9	Indonesia	-9,231.31
10	Germany	-5,518.09	10	Australia	-8,473.04
11	Hong Kong	-5,010.42	11	Japan	-8,222.99
12	Singapore	-4,629.42	12	Hong Kong	-8,111.81
13	Australia	-4,203.42	13	Singapore	-7,811.58
14	Kuwait	-4,159.95	14	Russia	-6,615.31
15	South Africa	-3,634.00	15	Nigeria	-5,628.40
16	Russia	-2,830.23	16	Malaysia	-5,429.16
17	Nigeria	-2,537.49	17	Germany	-5,084.76
18	Taiwan	-2,416.66	18	South Africa	-4,880.52
19	Malaysia	-2,315.38	19	Oman	-3,692.32
20	Argentina	-1,939.21	20	Thailand	-3,581.29
21	Belgium	-1,705.08	21	Taiwan	-3,477.85
22	Ukraine	-1,688.89	22	Guinea	-3,055.03
23	Angola	-1,620.14	23	Argentina	-2,775.80
24	Thailand	-1,444.68	24	Ukraine	-2,440.92
25	Guinea	-1,129.25	25	Angola	-2,272.63
26	Vietnam	-1,121.02	26	Bolivia	-1,954.58
27	Bolivia	-1,064.81	27	Peru	-1,809.83
28	Morocco	-929.21	28	Norway	-1,712.64
29	Peru	-756.19	29	Colombia	-1,587.61
30	Oman	-732.63	30	Morocco	-1,281.91
31	Kazakhstan	-579.01	31	Congo	-1,148.71
32	Colombia	-538.62	32	Gabon	-1,017.50
33	Ghana	-512.46	33	Jordan	-937.92
			34	Guinea	-873.13
			35	Vietnam	-735.85
			36	Ecuador	-707.53
			37	Finland	-531.92

Source: https://tradestat.commerce.gov.in

Table A5.3: Government Incentives for INR usage in trade – Status *(Contd.)*

Scheme	**Notification/Clauses**	**Remarks**
1. Interest Equalisation Scheme (IES) This is being implemented by the DGFT through Reserve Bank of India (RBI) for pre and post Shipment Rupee Export Credit. Under the Scheme, interest equalization @ 3% per annum available to MSME manufacturer exporters and @ 2% to all exporters (Merchant and large manufacturers) in respect of 410 tariff lines covering employment intensive sectors	RBI DOR.STR.REC. 93/04-02.001/2021-22 dated 08.03.2022.	The benefit is available on pre and post shipment Rupee credit.
2. Priority Sector Lending (PSL) Priority Sector Lending (PSL) pertaining to export credit is enhanced from Rs.250 million per borrower to Rs.400 million per borrower and the criteria of 'units having turnover of up to Rs.1 billion' is removed.	RBI Master Direction -FIDD. CO.PLAN.BC.5/04.09.01/2020-21 dated 04.09.2020 (updated as on October 2021)	The benefit is also available on Rupee credit.
3. Remission of Duties or taxes on Export product (RoDTEP) The RoDTEP scheme is to neutralise the taxes and duties suffered on exported goods which are otherwise not credited or remitted or refunded in any manner. The benefit is given as percentage of FOB or fixed amount per unit of measurement as prescribed in the Appendix 4R to the DGFT Notification. The Scheme benefit is available for 8555 tariff items.	CBIC Notification No. 76/2021-Customs (N.T.) dated 23.09.2021 & DGFT Notification No. 19/2015-20 dated 17.08.2021	The benefit is currently available on realisation of free foreign exchange (except in case of Iran, where the benefit is available for realisation in INR).
4. Rebate of State and Central Taxes and Levies (RoSCTL) The RoSCTL Scheme is eligible for the export of apparels and made-ups only, i.e., Chapter 61, 62 & 63. The Scheme provides rebate of the state and central taxes at the prescribed rates on FOB value of exports.	CBIC Notification No. 77/2021-Customs (N.T.) dated 24.09.2021.	The benefit is currently available on realisation of free foreign exchange (except in case of Iran, where the benefit is available for realisation in INR).

Table A5.3: Government Incentives for INR usage in trade – Status *(Contd.)*

Scheme	Notification/Clauses	Remarks
5. Duty Drawback Duty Drawback benefit is available in relation to any goods exported out of India as refund of basic Customs Duty paid on importation of such goods used in production of the exported goods through All-Industry at specified rates or Brand Rate fixation.	Notification No. 07/2020-Customs (N.T.) dated 28.01.2020 (Schedule).	Concerned section of the Customs Act 1975 required to be amended for grant of Drawback against realisation in INR.
6. Advance Authorisation Scheme Advance Authorisation (AA) is issued to allow duty free import of inputs, which are physically incorporated in export products (making normal allowance for wastage).	Chapter 4 of the Foreign Trade Policy.	The benefit is currently available on realisation of free foreign exchange (except in case of Iran, where the benefit is available for realisation in INR).
7. Duty Free Import Authorisation (DFIA) DFIA is issued on post export basis for products for which Standard Input Output Norms (SION) have been notified. Provisions of DFIA Scheme are similar to Advance Authorisation Scheme. However, DFIA being a transferable instrument, it only exempts Basic Customs Duty, SWS and Compensation Cess.	Chapter 4 of the Foreign Trade Policy.	The benefit is currently available on realisation of free foreign exchange (except in case of Iran, where the benefit is available for realisation in INR).
8. Export Promotion Capital Goods (EPCG) Scheme The Scheme allows exporters to import capital goods for pre-production, production and post-production at zero customs duty.	Chapter 5 of the Foreign Trade Policy.	The benefit is currently available on realisation of free foreign exchange (except in case of Iran, where the benefit is available for realisation in INR).
9. Export Oriented Units EOU)/EHTP/STP/BTP Under this scheme, the EOUs etc. are permitted to import and/ or procure from DTA or bonded warehouse in DTA or from international exhibition held in India without payment of Basic Customs Duty, SWS, IGST and compensation cess.	Chapter 6 of the Foreign Trade Policy.	The benefit is currently available on realisation of free foreign exchange (except in case of Iran, where the benefit is available for realisation in INR).

Table A5.3: Government Incentives for INR usage in trade – Status *(Concld.)*

Scheme	Notification/Clauses	Remarks
10. Deemed Exports Under the Scheme a level-playing field is provided to domestic manufacturers in certain specified cases decided by the Government from time to time.	Chapter 7 of the FTP	Deemed exports is eligible for any/all specified benefits in respect of manufacture and supply of goods, qualifying as deemed exports under the Policy.
11. Transport & Market Assistance (TMA) TMA Scheme covers all Agriculture Products between Chapter 1-24 except those in Annex. The objective is to mitigate disadvantage of higher cost of transportation of export of specified agriculture. Assistance given in cash through direct bank transfer as per reimbursement of freight paid. Assistance given in cash through direct bank transfer as per reimbursement of freight paid. Rates of assistance have been increased, by 50% for exports by sea and by 100% for exports by air. Originally, the scheme was available till 31.03.2020. it was further extended upto 31.03.2021 and again extended upto 31.03.2022 with addition of Dairy Products.	Department of Commerce Notification No. 17/3/2018-EP (Agri. IV) dated 27.02.2019	Currently, Government has decided to foreclose Revised Transport and Marketing Assistance (TMA) for Specified Agriculture Products Scheme to revamp, redesign and refocus it better for better outcomes
12. Market Access Initiative (MAI) Scheme Assistance under the Scheme is provided to the eligible agencies registered within the country to undertake initiatives and activities aimed at developing and strengthening export market for Indian goods and services such as any direct/indirect activities for exploration of new markets as well as consolidating the existing market, development of export-oriented entrepreneurship, training in exports, market research, capacity building, branding, meeting statutory regulations in importing markets.	Department of Commerce Notification No. No.11020/9/2021-E&MDA dated 19th July, 2021	Under the Scheme support includes to micro, small and medium enterprises to enter export market; nurturing innovation; developing trade and market intelligence; building appropriate skill set; addressing the interventions required towards exploring new markets abroad

Table A5.4: Charge structure for NEFT and RTGS transactions applicable to all member banks

<table>
<tr><th></th><th>NEFT</th><th>RTGS</th></tr>
<tr><td>Maximum ceiling charges that banks can levy from their customers, if they so desire.</td><td>DPSS CO (EPPD)/98/ 04.03.01/ 2012-13 dated July 13, 2012:
https://www.rbi.org.in/scripts/FS_Notification.aspx?Id=7448&fn=9&Mode=0</td><td>DPSS (CO) RTGS No.1926/ 04.04.002/ 2015-16 dated February 04, 2016:
https://www.rbi.org.in/scripts/FS_Notification.aspx?Id=10260&fn=9&Mode=0</td></tr>
<tr><td>Waivers</td><td colspan="2">RBI waived off the processing charges and time-varying charges levied on banks by RBI for outward transactions undertaken using the RTGS system, as also the processing charges levied by RBI for transactions processed in the NEFT system with effect from July 1, 2019:
https://www.rbi.org.in/scripts/FS_Notification.aspx?Id=11586&fn=9&Mode=0

<u>NEFT</u>
Member banks were advised not levy any charges on their savings bank account holders for funds transfers done through NEFT system which are initiated online.
https://rbi.org.in/scripts/FS_Notification.aspx?Id=11756&fn=9&Mode=0</td></tr>
</table>

भारतीय रिज़र्व बैंक
Reserve Bank of India

Central Office Building, Shahid Bhagat Singh Marg, Mumbai-400 001.