Diversification from Dollar

Why in news?

The RBI's permission to Indian importers and exporters to settle their transactions in the rupee is a significant step towards reducing India's dollar dependence and diversifying its foreign currency reserves.

What is the potential impact of dollar dependence in India?

- **Imports**- India relies on dollar-denominated imports for over 85% of its crude oil requirements and imports more goods than it exports.
- Therefore, India's import bill usually shoots up when the dollar strengthens, increasing the local demand for dollars.
- **Widening deficit**- It will widen the deficit between its imports and exports.
- **Balance of payments crisis**- If this gap gets out of control, it can lead to a balance of payments crisis (though risks of this are low in the current context).
- **FPI pullouts**- Foreign Portfolio Investor (FPI) pullouts worsen the situation because this further increases the domestic demand for dollars.
- **Depreciation of Indian rupee**- When the US dollar strengthens, the Indian rupee usually has no choice but to give in.
- Since the beginning of the year, the rupee has lost about 6% in value terms against the dollar.
- **Domestic inflation**- Many essential commodities and intermediate goods that India imports also get costlier, thus feeding into domestic inflation.
- **Remittance**- Indians who remit money in dollars to support relatives will need to shell out more.
- **Interest rate hike by RBI**- A fast-depreciating rupee can also force the RBI's hand in hiking interest rates more quickly or steeply than it originally intended.

To know more about the strengthening of dollar, click here

How will the settlement system in rupee work??

- The settlement mechanism has been designed in such a way that it needs the involvement of only the trading partner country and its banks.
- It enables invoicing of all exports and imports in rupee and settlement at a market determined exchange rate.
- Indian banks have been allowed to open special rupee vostro accounts of banks of the partner trading country.
- All payments made by Indian importers and receivables of Indian exporters will be channelled through these vostro accounts.
- This process has already been tested while paying for crude oil imports from Iran in rupee.

A vostro account is an essential part of correspondent banking in which a foreign bank *acts as an agent providing financial services on behalf of a domestic bank. Vostro is a Latin word that translates to "your," as in "your account".*

What is the significance of RBI's move?

- **Alternate method of trade settlement**- It allows settlement of all international trading transactions in the Indian currency thereby providing an enabling mechanism to enter into bilateral agreements with all willing trading partner countries to implement a different method of trade settlement.
- **Easy trade with Russia**- The move will immediately make processing of trade transactions with Russia easier as Russian banks were barred from using the SWIFT messaging system early this year.
- **Solves the exchange rate issue**- It could ease the burden on India's exchange rate and external account.
- Settling external trade in the rupee reduces India's vulnerability to period of dollar strength and the exchange rate volatility caused by domestic demand for the dollar perpetually outpacing supply.
- **Internationalization of rupee**- It is also a definitive step towards internationalising the rupee and an attempt to hedge against the overarching dominance of the US dollar.
- **Reduces geopolitical tensions**- It is the way ahead to avoid difficulties arising out of future geopolitical tensions.
- **Economic development**- With India's imports being higher than exports, there will be surpluses in the vostro accounts that can be used for permissible capital and current account transactions.

References

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