

## 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

1. <https://www.thehindubusinessline.com/opinion/editorial/diversifying-from-dollar/article6563634ecec>
2. <https://www.investopedia.com/terms/v/vostroaccount.asp>

