

## **‘An Internationalised Rupee?’**

### **I. Concept of Currency Internationalisation**

A currency can be termed ‘international’ if it is widely accepted across the world as a medium of exchange. Broadly, internationalisation of currency is characterized by the following: (a) payments for international transactions can be made in that currency; (b) both residents and non-residents can hold financial assets/liabilities denominated in that currency; and (c) freedom for non-residents to hold tradable currency balances, even beyond the territory of the issuing country. It is an indicator of the confidence that the external economy has in the economy of the issuing country, as it integrates with the global economy. Limited or full use of an ‘internationalised’ currency as legal tender in certain other countries is a possibility. Further, limited internationalisation within a geographical region is also possible. For example, the South African *rand* (ZAR) has the attributes and characteristics of an ‘international currency’ in the neighboring countries *viz.*, Namibia, Swaziland and Lesotho. However, internationalisation of a currency does not necessarily require removal of all capital controls and it is consistent with a regime characterised by less than full capital mobility.

The main economic factors underpinning internationalisation of currency are: (a) domestic stability which makes the currency attractive as a store of value; (b) a well-developed financial system with deep and liquid markets offering participants a wide range of services and products in terms of borrowing, investing and hedging; and (c) the bigger size of the economy as compared to the world output, financial markets and its significant role in trade, leads the outside world to increase the demand for internationalised currency for transaction purposes, and also to consider the use of such currency when making portfolio decisions. In sum, these factor includes all things which may contribute to speed, efficiency, reliability and user-friendliness of the currency and of instruments denominated in it.

### **II. History of Currency Internationalisation**

The pound sterling was the first currency in modern times to assume an international dimension, as a result of Britain’s dominant position in international trade and investment in the

nineteenth century. However, Sterling now has only a very modest role as an international currency as compared to its dominant position a century ago (Latter, 2000).

The US dollar owed its emergence as a major international currency initially to similar factors as did Sterling – namely the strength of the US economy and its weight in global business. The position was consolidated when the dollar was the only significant currency to remain fully convertible after the Second World War. The US dollar continues to be a dominant international currency despite wide swings in interest and exchange rates, reflecting highly developed and liquid markets that exist in the US dollar instruments.

Swiss *Franc* was at one time disproportionately important as an international currency, *albeit* in the rather narrow sense of being a haven for savings, rather than as a major vehicle for international trade or fund-raising. Switzerland's record of political stability and economic prosperity was one factor leading the attractiveness of the Swiss *franc*, but so also was the tradition of banking secrecy.

The emergence of Euro has a unique history. None of the currencies which have now merged to form the Euro were previously significant international currencies. The *deutsche mark* was the most in demand for such a role, but the German authorities were never keen to facilitate it to any great extent. In fact, their fiscal and regulatory regimes tended to discourage it. In contrast, at present, there are about 50 countries with an exchange rate regime linked to the Euro, including those States that have not yet joined the Euro area. The non-EU countries that use the Euro as an anchor currency are mainly located in the EU's neighboring regions or are countries that have established special institutional arrangements with the EU or some of the EU member states. In most of these countries, the Euro is also the main or the sole intervention currency used by the authorities to stabilise the exchange rates of their respective currencies. The role of the Euro as an anchor currency in third countries outside the Euro area has remained stable, overall. In using the Euro as an issuance currency, financial institutions and corporations, mainly from mature economies (USA, UK), have taken advantage of the greater size and liquidity provided by the increasingly integrated Euro-denominated bond markets (Mersch, 2004).

The Indian rupee was regarded as an official currency of other countries, including Kuwait, Bahrain, Qatar, the Trucial States (United Arab Emirates (UAE) since 1971) and Malaysia in previous times. The Gulf rupee, also known as the Persian Gulf rupee, was introduced by the Government of India as a replacement for the Indian rupee for circulation

exclusively outside the country with the Reserve Bank of India [Amendment] Act, May 1, 1959. This creation of a separate currency was an attempt to reduce the strain put on India's foreign exchange reserves. After India devalued the rupee on June 6, 1966, those countries still using it - Oman, Qatar and UAE - replaced the Gulf rupee with their own currencies. Kuwait and Bahrain had already done so earlier in 1961 and 1965, respectively.

### **III. Internationalisation of Indian Rupee**

Internationalisation of a currency is a policy matter and depends upon the broader economic objectives of the issuing country. There are various policy issues involved, like the extent of capital account liberalisation. There is a need for caution in approaching liberalisation in practice. Capital account liberalisation in the presence of macroeconomic imbalances is as likely to hurt as to help. Hence sequencing of reforms plays almost a decisive role in determining the impact of capital account liberalisation.

India's approach in this context has been reflected in a full but gradual opening up of the current account but a more calibrated approach towards the opening up of the capital account. While foreign investment flows, especially direct investment is encouraged, debt flows in the form of external commercial borrowings are generally subject to ceilings and with some end use restrictions.

India, at present, does not permit rupee to be officially used for international transactions except those with Nepal and Bhutan (Bhutanese *Ngultrum* is at par with the Indian Rupee and both are accepted in Bhutan. The Indian rupee is also accepted in towns of Nepalese side of Nepal-India border). Non-residents cannot hold rupee assets and more importantly, liabilities denominated in Indian rupee, beyond certain limits. For instance, no individual FII-sub account can hold more than 10 per cent of paid up capital of an Indian company. All FIIs, taken together can invest no more than US \$ 3.2 billion in government securities and treasury bills. In case of corporate debt, this limit is US\$ 1.5 billion. Non-residents cannot hold tradable rupee balances. Similarly, restrictions have been imposed on the domestic and international banks with respect to transactions in Indian rupee. The funds in *vostro* accounts (accounts in Indian rupee held by foreign banks) held by non-resident banks can be used only for the purpose of transactions with Indian residents.

The hallmark of international currency is that invoicing of tradable goods between countries is done in internationalised currency. In sharp contrast, almost the entire bulk of international trade in India continues to be denominated in the US dollars. Efforts to promote invoicing in the domestic currency have met with little success in countries with currencies which are not internationalised as the trade-counterparty does not have the necessary infrastructure to hedge his exposure in international markets.

India accounts for a very small proportion of the total foreign exchange market turnover in the world as compared to other countries. BIS Triennial Central Bank Survey data for 2007 shows that India's daily average share in the total foreign exchange market turnover is 0.9 per cent as compared to 34.1 per cent of UK and 16.6% of USA. However, India's share in total foreign exchange market turnover has been slowly but continuously increasing. India's share has increased from 0.1 per cent of the total foreign exchange market turnover in 1998 to 0.2 per cent in 2001 to 0.3 per cent in 2004 to the current 0.9 per cent.

The share of Indian Rupee in total currency turnover is also very small. Moreover, in case of the Indian rupee, spot transaction accounts for major part of currency turnover (42.6 per cent), while in case of both Euro and Dollar, the foreign exchange turnover is highly concentrated in foreign exchange swaps.

There is some anecdotal evidence that Indian rupee is accepted in Singapore, Malaysia, Indonesia, Hong Kong, Sri Lanka and the UK. The Central Bank of Nepal, *Nepal Rastra Bank*, also holds Government of India Treasury Bills.

There is growing demand for off-shore rupee-linked paper from real money accounts (who are not allowed to hold derivatives), given the caps on foreign investor flows to the Indian local currency debt market. Inter-American Development Bank (IADB) issued the first offshore rupee bond with a 3-year tenor for Rs. one billion in February 2007. In May 2007, IADB issued another offshore rupee bond with a 10-year tenor for Rs.1.5 billion. The World Bank placed a similar issue in June 2007 for Rs.1.25 billion with a 3-year tenor. European Bank for Reconstruction and Development issued rupee offshore bonds with a 5-year tenor for Rs.1.00 billion in July 2007 (Singh, 2007).

Internationalisation of currency has often been projected in the literature as one of the benefits of joining a currency union. This is in fact true in the case of Euro. India is, as yet, not considered a part of Asian Currency Unit (ACU). The currencies of the 13 major countries

included so far in ACU are – Singapore, Malaysia, Indonesia, Thailand, the Philippines, Brunei, Laos, Myanmar, Vietnam and Cambodia, plus China, Japan and South Korea (ASEAN +3).

In the region, India holds an important position in terms of economic growth and volume of trade. India has a growing role in Asia as an engine of economic growth. It is increasingly getting integrated with East Asian Countries. India's economy of more than a trillion US dollars is growing at a rate of nearly 8 per cent per annum. The value of the Indian rupee is market-determined and not pegged to any currency. India's foreign exchange reserves are amongst the largest in the region. There is scope to increase the volume of trade with ACU countries. The share of ACU countries in India's exports range around 6 per cent and in imports around 5 percent in recent years. The major goods that are imported from ACU are – petroleum, non-ferrous metals, pulses, chemicals, wood and products, iron and steel, and textile yarn, fabrics, made-up articles. The major exports to ACU are engineering goods, petroleum and chemicals.

Joining an international currency union has its merits and demerits. The merits are that such a union may eliminate exchange rate fluctuations and deter speculative attacks, reduction of transaction costs, economies of scale for firms operating in the region and greater trade and financial flows. The demerits are that it could lead to weakening of national sovereignty and limit the national government's power of economic management. However, significant cross-country variations in the size of the economy, stages of development, growth performance, inflation control, degree of openness, and other economic indicators among the ACU countries exist at present and these need to converge before a union or a currency unit can be considered viable.

#### **IV. Current Global Turmoil and Internationalisation of Indian Rupee**

The current global turmoil triggered by the sub-prime crisis in the US spread to other advanced economies, and gradually also took emerging economies into its grip. Several factors covering origin and distribute model of bank lending, regulatory arbitrage on non-banking financial entities, financial innovations in terms of complex financial derivatives and persisting global imbalances are considered as major factors leading to current crisis. Most importantly, it is argued that the combination of low real and nominal interest rates accompanied by abundance of liquidity induced by accommodative monetary policy especially in the US lies at the root of the current crisis. In this sense, the sub-prime is a symptom rather than a cause.

Increased financial flows and low inflation led to a decline in interest rates across the world, thus reducing the returns from traditional assets. As yields fell, banks started looking for new ways to increase their returns which led to a wave of financial innovations. There was a tremendous rise in the use of complex forms of securitisation and structured products. Banks were less worried about credit risk as the loans were subsequently sold to third parties. Hence they increased their lending volumes without caring much about the quality of credit and the credit worthiness of the borrower.

The emerging economies, with their limited exposure to mortgage backed securities were initially able to sustain their growth momentum and retain the confidence of international investors. However, as the turmoil continued in the developed economies, the effect on emerging economies became unavoidable. Emerging market economies are being affected both through real and financial channels.

The recent events have certainly highlighted the complexity and multiplicity of linkages among financial markets. Responses to large external shocks – for instance, the sharp rebound of the US dollar – once again demonstrated that feedback mechanisms due to leverage, payoff non-linearities in forex derivatives and similar other reasons can lead to great volatility in financial market prices, often involving overshooting on a major scale.

In order to address the crises, countries across the globe have responded with a mix of both conventional and unconventional measures as summarized below:

- In the US, authorities have supplemented their case-by-case approach that addresses points of distress as they arise, with a more comprehensive and systemic response. The new approach encompasses a wide-ranging set of measures, including liquidity support for banks and near-bank institutions such as broker dealers and money market funds; asset purchases to free up bank balance sheets; support for the housing market; extending deposit insurance; and restricting short selling. The actions taken by the U.S. authorities are intended to relieve pressures on financial balance sheets and to restore confidence. These measures are positive, comprehensive, and necessary; their goal is to provide a catalyst for private markets to support asset prices, open up funding, and allow the rebuilding of capital cushions.
- In Europe, measures to improve funding have been coordinated within the euro area through the ECB's operations, and internationally dollar liquidity needs have been alleviated through swap facilities between European central banks and the Federal Reserve. EU-wide action is also under way to improve supervisory capital requirements and other aspects of market structure.
- Responses in other countries include- large provision of both overnight and term liquidity often against a wider pool of collateral ; Policy rate cuts; Collateral swaps; direct or indirect purchases of illiquid assets; introduction or increase in foreign currency swap

lines; partial/full guarantee of bank debt; increased depositor protection; restrictions on short selling of equities; provision of capital to banks; and nationalisation of distressed financial institutions.

A flexible exchange rate in many cases served as a safety valve. But the size of some recent movements, not justified by the local economic situation, had the potential to be very disruptive. As already noted, leverage and non-linearities in forex exposures led to some destabilising dynamics at least in the short run. The scale of forex intervention was unusually large; in several cases, however, intervention was designed to minimise the effect on the process of price formation in the forex market. The volatility of portfolio flows (and market prices) was magnified by abrupt adjustments by banks and other financial firms in the main centres. One aspect of the adjustments was deleveraging (or attempted deleveraging) of major international banks, hedge funds and so on. Another was a reduction of resources devoted to market-making in often illiquid markets: because foreign institutional and retail investment in local bond and equity markets was typically channelled through major international banks willing to work continuously make markets in such instruments, the sharp cut-back of trading desks has major implications.

The crisis has also raised new questions about measures of reserves adequacy. Countries that, by conventional criteria, have more than ample reserves were hit very hard. Possible reasons include the accuracy of simple measurements of underlying forex exposures from short-term external debt (in particular, allowing for exposures through derivatives) and the flight of domestic capital. One simple prescription that central banks should use foreign exchange reserves to address these pressures did not prove to be fully realistic. Explanations put forward for the impracticality of that prescription include the assertions that any too-rapid drawdown of reserves under exchange market pressure would risk sending a signal of vulnerability to the market; that a crisis heightens uncertainty about the future, so reserves should be assiduously managed; and that selling large volumes of reserves puts additional strain on the markets for local currency bank funding.

In view of the unfolding of the crisis, the focus of the policy maker is on maintaining adequate liquidity in the economy and facilitating growth. In recent months, growth estimates for the economy have consistently been revised downwards and we have recorded net outflow of capital

from the country. Consequently, foreign exchange reserves have depleted and the external value of the Indian rupee has been declining.

## **V. Perceived Costs and Benefits of further Currency Internationalisation**

There are number of benefits that a country derives from its currency being internationalised. Internationalisation of a currency may promote growth by facilitating greater degree of integration both in terms of foreign trade and international capital flows. Other important benefits are - savings on foreign exchange transactions, reduced foreign exchange exposure, economies of scale and seignorage. On seignorage, it must be mentioned that the USA which enjoys considerable advantage on this account ensures that there are sufficient quantity of US banknotes, of the right denominations, available for external shipment and that the distribution channels operate efficiently.

However, the policy maker needs to be cautious, as internationalisation of the domestic currency has several disadvantages. A major problem with the internationalisation of a currency is that it can increase the issuing country's vulnerability to external shocks, given the freedom to residents as well as non-residents with respect to the flow of funds in and out of the country and from one currency to another. If large amounts of domestic currency are held by non residents, particularly at offshore locations, any expectation that the currency is vulnerable due to weak fundamentals, can turn out to be self-fulfilling and can lead to a sell-off resulting in a sharp fall in the value of the currency. A potential risk of internationalism is the withdrawal of short-term funds and portfolio investments by non-residents. Moreover, currency internationalisation has an impact on the effectiveness of various monetary policy instruments. For example, the effectiveness of open market operations as an instrument for influencing interest rate and money supply is likely to reduce in an environment where residents and non-residents are free to buy and sell domestic currency. This is more likely to happen in countries where the market for government debt is neither very large nor liquid.

## **VI. Impact of Currency Internationalisation on Volatility of Foreign Exchange and Capital Flows**

With rapidly expanding financial globalisation, issues related to management of foreign exchange rate and foreign exchange reserves have become increasingly complex. The determinants of exchange rate behaviour have altered dramatically. Earlier, factors affecting

merchandise trade flows and the behaviour of goods market provided proximate guides for operating monetary policy. In this environment, a monetary policy principally targeting low inflation was relevant and commodity purchasing power parities seemed to offer a satisfactory explanation of exchange rate changes. Since the 1980s, vicissitudes of capital movements have shown up in volatility in exchange rate movements with major currencies moving far out of alignment of underlying purchasing power parities. On a day-to-day basis, it is capital flows which influence the exchange rate and interest rate arithmetic of the financial markets. Instead of the real factors underlying trade competitiveness, it is expectations and reactions to news which drive capital flows and exchange rates, often out of alignment with fundamentals.

The overall experience, is that capital flows are characteristically volatile, both in terms of longer term waves and even more so in the short term. The longer term waves influence monetary policy thinking during each era, whereas the short term volatility has to be met through day to day monetary policy operations. Capital flows typically follow a boom-bust pattern and in more recent times, the importance of capital flows in determining the exchange rate movements has increased considerably, rendering some of the earlier guideposts of monetary policy formulation possibly anachronistic.

In the context of choosing an exchange rate regime, the weight of experience seems to be tilting in favour of intermediate regimes with country-specific features, without targets for the level of the exchange rate, the conduct of exchange market interventions to ensure orderly rate movements, and a combination of interest rates and exchange rate interventions to fight extreme market turbulence. In general, emerging market economies have accumulated massive foreign exchange reserves as a circuit-breaker for situations where unidirectional expectations become self-fulfilling.

Moreover, the impact of greater exchange rate volatility has been significantly different for reserve currency countries and for developing countries. For the former, mature and well-developed financial markets have absorbed the risks associated with large exchange rate fluctuations with negligible spillover on to real activity. Consequently, the central bank does not have to take care of these risks through its monetary policy operations. On the other hand, for the majority of developing countries, which are labour-intensive exporters, exchange rate volatility has had significant employment, output and distributional consequences, which can be large and persistent.

In recent months, the exchange rate of the Indian rupee has moved over a wide range. The Reserve Bank only attempts to contain volatility but does not target any level of exchange rate, which is mainly market determined. The volatility in the exchange rate impacted the traders and also the capital flows in the economy. In the present situation of global uncertainty, any further attempt towards capital account convertibility or internationalization of the currency may not be appropriate for our economy.

## **VII. Micro and Macro Prudential Measures**

In many countries, the traditional view of banks has changed in recent years. From being originators of loans and bearers of risk, banks have become mere originators of loans and distributors of risk. First, the availability of information technology has reduced the cost of information collection and maintenance considerably. Thus, a widespread belief has arisen that information on credit quality of small borrowers who may be widely dispersed across jurisdictions can be made impersonal, packaged, processed, and sold. Second, with the availability of such technology, and the belief that such information was available on a structured basis, a great deal of financial innovation could take place which essentially enabled the investor or risk taker to become progressively remote from the ultimate borrowers where the actual risks lay. A whole host of intermediaries in the form of mortgage brokers, mortgage companies, societies and the like were then able to package their mortgage assets including non conforming loans and sell down to different categories of investors, including Special Investment Vehicles (SIVs), hedge funds and the like, most of whom were not regulated. The guiding principle behind this activity was that it is feasible for credit rating agencies to have enough information on a continuous basis to rate the instruments that had been packaged. It can certainly be argued that this is not a new development since mortgage backed securities (MBS) and asset backed securities (ABS) have been with us for some time and have been successful in providing liquidity to credit markets on a continuous basis without any accidents. The difference perhaps is that MBS packaged by the government sponsored entities (GSEs) were subject to certain relatively well enforced norms that presumably reduced the potential risk embedded in these instruments.

These considerations lead to the very important issue that relates to the role of effective financial regulation and supervision. The recent crisis has underscored the need for strengthening of oversight of advanced financial markets. Traditionally, financial surveillance has placed relatively more emphasis on banking regulation, the idea being that banks are trustees of public money. Hence they need to be effectively regulated and supervised to maintain public confidence in the system. On the other hand, investors in hedge funds are high net worth individuals who do not need such protection. They are informed investors who are able to exploit the information efficiency of markets and, therefore, should be able to understand the risks implied by information asymmetry. The current crisis was, however, triggered by the difficulties encountered by these investors who had taken large exposures to sub-prime related investments without having accounted for the potential risks embedded in these instruments. There have been a host of ills underlying these transactions, which are now coming to light. We need, however, to abstract from the details of all the malpractices that have led to the current situation and reflect on the incentive structure that led to these malpractices. The links between banks and non bank financial intermediaries, and other off balance sheet exposures were not adequately recognised or recorded by banking supervisors.

In the context of recent events, it is important to recognise that there is a need to understand better the process of transmission of risk information through various segments of the financial markets in order to address the crisis of collateral in the credit market. How much of the specialised information that rests with lenders can be systematised, packaged and transmitted to markets as credit ratings. The principle underlying securitisation is based on the lender having this specialised information which can be unbundled and sold in the market separately in tradable sizes. A large part of the market for structured finance products is over the counter. A number of issues arise here - Can these products be further standardized so that they can be traded on an exchange which enables greater transparency from the point of view of the investor? Are there better ways of generating more objective information on the market value of collaterals, especially in situations where collaterals are not fully marked to market since such information may not be available on ongoing basis? Are there limits to marking to market certain kinds of assets whose values are not available on a high frequency basis?

A challenge for policymakers is to achieve the appropriate balance between the micro prudential and macro prudential approaches to financial sector oversight. The micro prudential approach is bottom up while the macro approach is top down. In the case of the banking sector the macro prudential analysis is based on both back ward looking indicators such as balance sheet profitability asset quality and capital adequacy as well as forward looking indicators which identify major risk facing the banking sector.

In India, the financial sector, especially banks is subject to prudential regulation with respect to both liquidity and capital. A number of steps have been taken by the Reserve Bank with a view to mitigating liquidity risks, at the very short end, systemic level and institution level *viz.* (i) participation in the unsecured overnight money market has been restricted to banks and primary dealers and ceilings have been stipulated on the borrowing and lending operations in the market; (ii) prudential limits have been imposed on banks' interbank liabilities in relation to the net worth; (iii) asset-liability management guidelines have been framed that take cognizance of both on and off-balance sheet items; and (iv) a detailed policy on liquidity support to Special Purpose Vehicle has been outlined in the guidelines on securitisation of standard assets.

With the objective of further strengthening capital requirements, the credit conversion factors, risk weights and provisioning requirements for specific off-balance sheet items including have been reviewed. Furthermore, in India, complex structures like synthetic securitisation have not been permitted so far. Introduction of such products when found appropriate would be guided by the risk management capabilities of the system.

Detailed guidelines have been issued by the Reserve Bank on the implementation of the Basel II framework covering all three pillars. Minimum CRAR of 9 per cent has been prescribed. Banks have been advised to bring Tier1 CRAR to 6 per cent before March 2010. All foreign banks operating in India and Indian banks operating outside India were required to migrate to Basel II by March, 2008 and all other scheduled commercial are to migrate to Basel II by not later than March 31, 2009.

It is now recognised that the current microeconomic-driven prudential regulatory framework, including Basel II is procyclical which further worsens the impact of crises on institutions. In 2000, the Bank of Spain introduced a dynamic, rules-based loan-loss provisioning system in which provisions increase in periods of higher credit growth and economic expansion,

and decrease in times of low or negative growth, thereby contributing to smooth income and capital over time. RBI also did something similar when we increased the risk weight as also the general provisioning requirement on exposures to sectors which showed high credit growth. This was reduced recently when growth moderated.

Successively, additional prudential regulations with respect to exposures to specific sectors such as the real estate, housing loans to individuals and consumers credit have been imposed on the lines of dynamic provisioning. Furthermore, the supervision of Non Bank Finance Companies (NBFCs) have been tightened with a view to reduce regulatory arbitrage vis-à-vis the banking sector. The regulatory requirements are also higher for deposit taking NBFCs vis-à-vis non deposit taking NBFCs which has helped to contain leverage in this sector.

### **VIII. Concluding Observations and Lessons for India**

The initial effect of the crisis on India was muted, as was the case with most emerging economies. Capital flows were increasing till September- October 2007. There was a negligible effect on Indian banks and financial markets because of limited exposure to complex derivatives, as also due to low presence of foreign banks in India (and Asia for that matter). There was however, some increase in volatility of capital flows and commodity prices. As second round effects, India experienced a mild reversal in capital flows, slowdown of external commercial borrowings (ECB) and some pressure on the exchange rate. Still the impact was not significant. Growth was projected at 8 to 8.5 per cent and inflation continued to be the major worry of policymakers. However, the crisis gradually intensified, effectively after the collapse of Lehman Brothers in September 2008. The main channels through which India has been affected are (a) a reversal in capital flows (FIIs, ECB, short term trade credit), (b) crash in the stock market which has hit investor confidence, affected valuation, and has led to the drying up of equity capital, and (c) slowdown in exports. As external funding dried up, pressure mounted on domestic resources. There has been a drawing down of liquid mutual funds and increase in pressure on Non Banking Finance Corporations. In nutshell, our current problems are – capital outflow, drawdown of reserves, pressure on exchange rate and corresponding liquidity crunch. Hence the Reserve Bank of India faces the responsibility to increase liquidity and maintain money supply at adequate levels. The Bank has taken several steps to ensure this.

The experience and lessons of the present crisis will be extremely useful for us in going forward with the process of financial market liberalisation. While there is not and should not be any stifling of innovations in the financial sector, it is important to distinguish financial innovation from conventional product, service or process innovation in terms of the systemic costs these entail. Socially useful as it is, financial innovation should not be allowed to outpace its understanding by the multitude of market participants and stake holders – a process facilitated by appropriate reporting, accounting and governance standards and enforced by regulatory and supervisory regime.

Challenges for public policy are manifold for a large and diverse economy like India that is undergoing structural transformation in a highly uncertain global environment and has a low per capita income. Recent global developments have considerably heightened the uncertainty surrounding the outlook on capital flows to India, complicating the conduct of monetary and liquidity management. In such scenario, cautious movement in terms of internationalising the currency is in order. There are indications to believe that Indian rupee is gaining acceptability in other countries. However the size of the country in terms of GDP, volume of trade as also the turnover in the foreign exchange market when compared with global dimensions, is small. The Indian rupee is rarely being used for invoicing of international trade. Therefore, internationalisation of the rupee is still a distant objective of policy makers in India.

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