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RUPEE MATTERS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Foreign Capital, Foreign Trade & BOP

Over the past few years, there has been consternation, understandably so, over the sharp rise in offshore rupee trading volumes. Data from the Bank of International Settlements pegs daily offshore rupee trading at around $16 billion in 2016, almost equal to onshore trading. More recent data from the Bank of England pegs offshore rupee trades at $23 billion in 2018. These large volumes in the offshore market indicate greater investor interest in the rupee. But they also raise troubling questions over the forces that “determine the rupee’s value”, and the ability of the central bank to ensure “currency stability”.

Typically, offshore markets allow participants to trade in a non-convertible currency. These markets have evolved for currencies where restrictions are imposed in domestic markets on foreign exchange convertibility. The constraints on foreign participation in domestic currency markets stem from cumbersome documentation and KYC requirements, restrictions on products, inconvenient trading hours. These restrictions push investors to trading in offshore markets to hedge their currency risks. But with the volumes in these markets growing, they have begun to play a critical role in “price discovery”, more so during “periods of uncertainty”. The Task Force on Offshore Rupee Markets has pointed to two instances — the taper tantrum in the 2013 and the 2018 emerging market crises — when the offshore market was driving the onshore exchange rate. This, as the report points out, “reduced the efficacy of foreign currency intervention by the central bank”.

The task force has made several recommendations to incentivise market participants to shift to onshore markets, like extending onshore market hours, examining issues of taxation. Allowing market participants to take exposure upto $100 million, without having to establish the existence of the underlying risk, is also a step in the right direction. This will enable foreign investors to hedge their currency risk and could incentivise greater participation in rupee denominated bonds. As the economy grows, it makes sense for regulators to expand onshore currency markets, in a calibrated manner. The ability to hedge currency risks is also likely to increase the rupee’s attractiveness for trade invoicing and portfolio diversification, creating conditions for a gradual internationalisation of the currency.

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