A Primer on the Rupee Trade Settlement Mechanism

A primer on the development of an Indian Rupee Trade Settlement system. The article provides the rationale behind the establishment of this mechanism as well as the policies implemented to date.

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January 24, 2024

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1. INTRODUCTION

Settlement currencies are an important linchpin of international trade. They are the channels through which global commerce flows and its benefits are accrued to its proprietors i.e. the home economy. Simply put, a trade settlement currency is the currency using which an international transaction takes place. An importer pays for the product being imported using the settlement currency, which is credited to the exporter's account.

If we analyse the current landscape of global trade, it is evident that settlement of international trade transactions is heavily skewed in favour of currencies of developed nations.

Currency	% share in international trade transactions
Dollar (USD)	60
Euro (EUR)	20
Yen (JPY)	6
Pound Sterling (GBP)	5
Others (incl. INR)	9

Source: Global Trade Research Initiative (GTRI)

The recent geopolitical and economic developments, especially post Covid-19, have led to a shift away from conventional currencies. Many nations are exploring the feasibility of the idea and are conceptualising systems that will allow for settlement in alternate currencies, including their local ones. The objective behind this approach is to simplify international trade deals and to establish a counterweight to the dominance of a select group of nations over the global trade network.

This article attempts to review the evolving trade settlement currency landscape and provides a background on the system of settlement of foreign trade transactions in Indian rupees. This is a vital initiative in not only facilitating the business growth of Indian exporters but also making the rupee an internationally recognised, global trade currency.

2. CASE STUDIES: THE EXPERIENCE OF CHINA AND JAPAN IN INTRODUCING LOCAL CURRENCY SETTLEMENTS

Lessons can be taken from the experience of countries like China and Japan, whose currencies are taking market share away from incumbents such as the USD and EUR. Within these takeaways, one finds policy overlaps as well as certain idiosyncratic characteristics.

In China, policies focused on the improvement of capital flows and monetary structures. The convertibility of the capital account was increased, albeit in a methodical and controlled manner. Priority was also given to the construction of a well-regulated and robust financial system. China leveraged the existing infrastructure in Hong Kong for this purpose.

Meanwhile, the increase of the Japanese yen’s influence in global trade was brought about by deregulation of cross border capital transfers and a rise of Japan’s share in the total volume of global trade. The common factor from both these nations’ efforts can be found in the nature and composition of their international trade. Both nations established trade agreements and partnerships with countries in their geographical proximity. Additionally, research shows that a high concentration of developed nations amongst a country’s list of export destinations has a negative impact on the use of its local currency in trade settlements. (Tavlas and Ozeki, 1991) Thus, both countries took steps to diversify the list of their trade partners.

3. NEED OF A RUPEE TRADE SETTLEMENT SYSTEM

India's economy ranked fifth globally in terms of GDP (current US dollars), fourteenth globally in terms of total exports and eleventh in terms of total imports in 2022. However, according to the BIS Triennial Central Bank Survey 2022, just 1.6% of the worldwide forex turnover, in terms of daily averages of the foreign exchange market, was accounted for by the Indian rupee. The survey suggested that INR may be considered a worldwide currency, representing India's place in the world economy, if its turnover increases to the level of the non-US, non-Euro currencies' 4% stake in the global forex turnover.

In this context, using quarterly data between 2004 and 2017, Chinoy and Jain (2019) suggest that global growth and exchange rates are key factors in determining the dynamics of India’s exports. Moving from a foreign currency settlement system to a rupee denominated one will precipitate multiple benefits. Research indicates that the impact of USD/EUR exchange rates on a nation’s trade volume is directly proportional to the share of its foreign trade denominated using these currencies. Moreover, it was also observed that a higher share of USD/EUR invoicing in foreign trade led to greater exchange rate pass through effect. (Boz. et al, 2022) Exchange rate pass through is a phenomenon where a country’s inflation is affected by the exchange rate of the local currency with respect to foreign currencies. The global financial crisis of 2008 precipitated reduced liquidity in the USD which affected international trade levels due to the USD’s outsized role as a settlement currency.

Introduction of a rupee trade settlement system would thus, protect India from its trade balance being affected due to exchange rate fluctuations. This benefit can be extended to India’s trade partners as well. This would particularly help the nations facing forex shortages to maintain their current trade levels. Introduction of rupee/local currency trade settlements would also help exporters avoid losses due to double conversion and accelerate LC (letter of credit) issuances by banks/financial institutions.

4. AIDING THE EXPORT COMPETITIVENESS

The current global trade arena has been facing multiple threats in the form of geo-political conflicts, persistent inflation and debt sustainability issues among the trading partners across the globe. Countries have resorted to raising policy rates and reducing public expenditures to address the problem of sticky inflation. This monetary tightening, especially by the US and EU, has resulted in currency depreciation in most of the developing world due to withdrawal of investor funds from these economies. Strong currency depreciation usually results in higher import prices for energy and food, which raise inflationary pressures. Additionally, it deteriorates the current account balance and may make it more difficult for a nation to pay for necessary imports or pay off debt from abroad.

On the surface, the economy benefits from the rupee's depreciation. The weaker the local currency is, the more purchasing power it affords foreign customers, making India's exports more competitive. For Indian consumers, however, the identical procedure results in higher import costs. This implies that as import inputs grow more costly, producers and exporters will have to pay more for production and processing, affecting the micro and small exporters the most.

However, under the rupee trade arrangement, the Indian exporters need not incur extra cost, of hedging their exchange risk, to their product cost. Additionally, the element of political risk, related to the shortage of forex reserves in the destination country, is also expected to be addressed, leading to a substantial increase in the export competitiveness of the Indian exporters, especially the MSME sector.

5. POLICY INITIATIVES IN THE INDIAN CONTEXT

The Government of India has been making considerable efforts – both internally as well as on the international stage – to streamline the incorporation of a rupee settlement system. With this objective in mind, the RBI permitted the invoicing and payment of international trade transactions in rupees on 11 July 2022. It officially notified AD (Authorised Dealer) Banks of the facility to open and operate Special Rupee Vostro Accounts (SRVA). Banks/financial institutions from foreign countries will have the ability to open SRVAs with authorised banks in India. This system will enable all imports and exports to be denominated and invoiced in rupees. Indian exporters shall be paid the export earnings in rupees from the SRVA account of the foreign bank.

20 AD banks in India are permitted to open 92 Special Rupee Vostro Accounts of partner banks from 22 countries as per the approval from the RBI. The countries are –

- Bangladesh	- Mauritius
- Belarus	- Myanmar
- Botswana	- New Zealand
- Fiji	- Oman
- Germany	- Russia
- Guyana	- Seychelles
- Israel	- Singapore
- Kazakhstan	- Sri Lanka
- Kenya	- Tanzania
- Malayasia	- Uganda
- Maldives	- UK

Source: *https://www.wionews.com/business-economy/at-least-22-nations-in-talks-with-india-to-trade-in-rupee-finance-minister-636169*

Other notable developments include the fact that 100% of India's bilateral trade with Bhutan is being settled in rupees. The signing of a MoU between India and the UAE in July 2023 is expected to accelerate the implementation of a Local Currency Settlement System between the two countries. Under this system, bilateral trade deals would be invoiced, paid and settled using the countries' local currencies, namely the rupee and the UAE dirham.

Amongst the aforementioned list of countries, Russia and India have a significant trade partnership, with the total bilateral trade valued at approximately Rs. 40 million lakhs in FY 2022-23. This volume represents the high potential for the incorporation and growth of rupee trade settlement. Not only would it improve ties with a major trading partner, it would also serve to raise the share of INR settlements vis-à-vis India's total international trade. It reduces the dependency of Indian exports on foreign currencies and the risks inherent therein. Progress has already been made on this front – Russia's Gazprombank opened its SRVA with UCO Bank and has already paid for Indian imports using INR. UCO Bank has also received requests from other Russian banks to open SRVAs. These developments lay a solid foundation for the eventual settlement of oil transactions - which make up a large share of Indo-Russian trade – using rupees.

6. THE PATH FORWARD

The progress made so far can be supplemented and built upon by other policy actions. An Inter-Departmental Group constituted by the RBI in 2021 made certain recommendations to accelerate the establishment of the rupee trade settlement system.

The short-term policy suggestions included measures such as introduction of Indian Rupee as an additional transactional currency in existing multilateral agreements, integration of Indian payment systems with international counterparts to simplify cross border payments and inclusion of Indian government bonds in international bond indices.

The group's long-term recommendations include reviewing the taxes imposed on INR denominated bonds issued outside India (also known as masala bonds), international implementation of the RTGS system, reconciliation of the taxation structure of Indian financial markets with global financial centres and allowing Indian banks to offer banking services in INR through offshore branches. The recommendations are in line with the empirical research conclusions and experiences of other developing nations discussed earlier. They focus on facilitating capital flows in INR as well as strengthening the local financial infrastructure.

A country's welfare clearly increases when its currency is recognized internationally (Zhang, 2014). Gains in seigniorage from foreigners and increased trade prospects are the two main drivers of the Indian rupee's internationalization.

The successful implementation and expansion of the rupee trade settlement system is expected to bring about a wide range of benefits for India as well as its trade partners. It will also serve to reduce the high degree of concentration observed in the currencies used in international trade settlements. Finally, it is an important step in the process to cement the increasingly significant position of the INR and the Indian economy in the global economic landscape.

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