Trade in Local Currency for South-South Cooperation: A Case of India's Rupee Trade Scheme

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Introduction

Exchange rate volatility causes uncertainty in export proceeds and increases cost of hedging for exporters. Its adverse effects fall disproportionately on the Least Developed Countries (LDCs) and small countries as export baskets of these economies are narrow and foreign currency reserves stock are low. Regardless of the level of economic development, countries very often face risk of exchange rate fluctuations, which in turn affect export competitiveness. Argentina, a leading emerging market, is on the verge of a currency crisis now as the Argentinean Peso has depreciated by 18 per cent in 2018 over the last year. The unprecedented rise in the general price level in Venezuela may also put pressure on country's currency. An analysis of the exchange rate movements measured in terms of annual percentage change for 37 currencies suggest that currencies of nine countries have experienced more than 10 per cent depreciation in 2018 compared to the previous one. These include Brazilian Real (30.71 per cent), Indian Rupee (10.79 per cent), Indonesian Rupiah (10.79 per cent), Nepalese Rupee (10.5 per cent), Pakistani Rupee (17.92 per cent), Russian Ruble (16.23 per cent), South African Rand (12.55 per cent), Swedish Krona (14.2 per cent) and Tunisian Dollar (14.22 per cent). The magnitude of depreciation for Brazilian Real was 30.71 per cent, the steepest among all the depreciated currencies. In addition, 21 currencies have depreciated, including seven such currencies,

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which experienced depreciation to the magnitude of 5 to 10 per cent. Moreover, the history of random and erratic episodes of exchange rate volatility in the crisis years in 1990s and 2000s are well-known.

While both large and sudden appreciation and depreciation of home currencies against major invoicing currencies are harmful for exporting nations for maintaining export competitiveness, depreciation adds another layer of anxiety in terms of servicing external debt. The repayment liability in terms of domestic currency units becomes higher as cost of buying one unit of foreign currency becomes higher for the depreciated currency compared with the pre-depreciation level. The larger is the size of the depreciation, the larger would be incremental debt servicing burden on the concerned economy. The severity of exchange rate-induced adjustments can distort real sector activity if it persists. Traders generally resort to hedging to curb excess volatility in the exchange rate. In worst case, the central bank intervenes in the foreign exchange market to contain the magnitude of variations in the predictable band. Countries having floating exchange rate system generally do not prefer to intervene in the foreign exchange market so frequently unless the situation warrants it. In the recent years, trade in local currency is being viewed as an effective way of mitigating impact of exchange rate movements on exports and imports. Trade in local currency happens through a currency swap arrangement between any two countries or through a separate export promotion scheme.

Trends in Global Currency Use

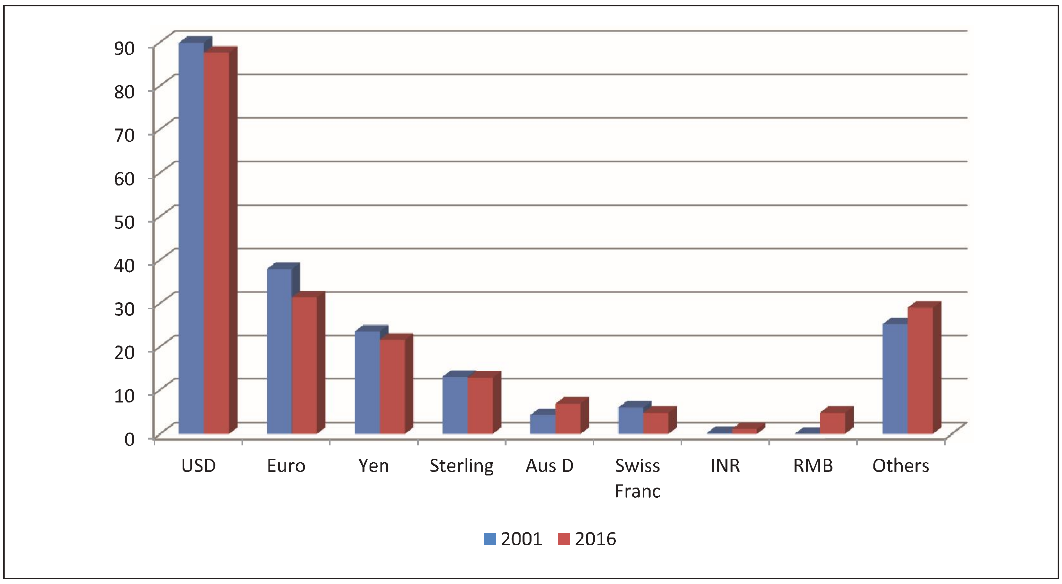
The trends in global currency use for trade invoicing and financial transactions have revealed interesting facts. For the past several years, one single currency, i.e. US Dollar (USD), dominated global trade and financial transactions, accounting for almost 90 per cent of the currency distribution in over-the-counter (OTC) foreign exchange turnover and around 80 per cent for export invoicing. However, the share of USD has gone down over the years even though it continues to retain its status as the most preferred currency for global transaction. USD comprised 89.9 per cent of OTC foreign exchange turnover in 2001, and it dropped to 84.9 per cent in 2010. The use of USD peaked up again to 87 per cent in 2013 and to 87.6 per cent in 2016. The market share of other three advanced country currencies such as euro, yen and Australian dollar has also decreased over time. For instance, the share of euro and Japanese yen decreased from 37.9 per cent and 23.5 per cent in 2001 to 31.4 per cent and 21.6 per cent in 2016, respectively. On the other hand, emerging market currencies have gained market share; most notably the Chinese currency, renminbi (RMB) (*see* Fig. 1).

The share of RMB almost doubled in three years with elevation of its global rank to 8 in 2016 from 9 in 2013. From 2.2 per cent share in 2013, RMB reached a market share of 4 per cent in 2016, outpacing Mexican peso. The rise in the share of RMB is attributed to increased trading against USD (BIS, 2016). Like RMB, Indian rupee (INR) experienced a steady rise in its market share in global foreign exchange turnover. With 0.2 per cent market share and 21st rank in 2001, INR moved up significantly to 0.9 per cent and 15th rank in 2010. Although the rank of INR slipped marginally to 18, its market share increased to 1.1 per cent in 2016. Among other emerging market currencies, Brazilian real and South African rand retained their market share around 1 per cent of global foreign exchange turnover over the period 2001-16.

USD is still the major invoicing currency for trade transactions in many countries of the world. Many advanced countries invoice a large part of their exports in home currencies whereas the developing countries depend still on USD for trade invoicing. Exports denominated in home currencies constitute more than 50 per cent of the total exports in Germany, Italy, Netherlands and United Kingdom. For Italy and Netherlands, the share of home currency increased significantly from 40 per cent and 43.8 per cent in 1995 to 72.6 per cent and 56.4 per cent in 2012, respectively. Unlike other advanced countries, home currency use in Japan was around 40 per cent. With regard to international currencies, USD still considered for trade to a very great extent globally as the proportion of exports invoiced in USD has not drastically declined even for developed countries.

USD-denominated exports is still around 25 per cent or more for Germany, Italy, United Kingdom and more than 35 per cent for Netherlands. In Japan, USD usage is up to 50 per cent of its exports. In contrast, USD remains the vehicle currency for trade invoicing in the developing countries. In India, USD constitutes 88.4 per cent of export transactions; marking

Figure 1: Currency Distribution of OTC Foreign Exchange Turnover (%)



Source: BIS (2016); Note: OTC = Over-The-Counter.

increase of 7.5 per cent over 1995 (*see* Table 1). For other developing countries including Indonesia, South Korea and Thailand, the share of USD in export invoicing in 2012 was 93.3 per cent, 85.1 per cent and 79.7 per cent, respectively. It signifies the dominance of USD in global trade transactions. Interestingly, invoicing of exports in home currency has been rising in developing countries. South Korea and Thailand experienced dramatic elevation of their currencies in export invoicing. The share of home currencies increased from 0.1 per cent in 1995 to 2.2 per cent in 2012 for South Korea and from 2.4 per cent in 1995 to 10 per cent for Thailand. In nutshell, the recent trends in currency distribution in global trade and foreign exchange transactions indicate growing use of emerging market currencies, although the reserve currency status of USD still remains undisputed.

Rupee Trade Scheme by India

India has experimented limited form of trade in local currency through the rupee trade scheme with Nepal, Russia and Iran. The basic purpose of this scheme was to provide an arrangement for settlement of payments relating to bilateral trade between India and these three countries. The Foreign Trade Policy 2015-2020 of India provides latest details of this provision. As per India's renewed trade treaty with Nepal in 2009, "Both Contracting Parties shall make provisions so that no discrimination will be made in respect of tax, including central excise, rebate and other benefits to exports merely on the basis of payment modality and currency of payment of trade. This would be made effective from the date to be mutually agreed to, after which the Protocol to Article III would become redundant." (This change has come into effect from 1 March 2012.) As a result, imports from India are normally paid for in Indian Rupees, since the currency is

Table 1: Use of Home and Major Currencies for Export Invoicing (%)

Country	Home Currency		USD		Euro		Yen	
	1995	2012	1995	2012	1995	2012	1995	2012
Germany	74.7	64.6	-	25.6	74.7	64.6	0.9	-
Italy	40.0	72.6	21.0	24.3	18.0	72.6	0.6	-
Netherlands	43.8	56.4	20.6	37.6	18.5	56.4	0.6	-
UK	61.6	51.1	23.1	28.8	4.0	3.1	1.1	0.4
Japan	37.6	39.4	51.5	50.3	2.4	5.4	37.6	39.4
Australia	-	13.7	-	84.0	-	1.0	-	1.9
New Zealand	-	22.0	-	59.0	-	5.4	-	1.9
India	1.8	-	80.9	88.4	5.4	7.0	0.5	0.1
Indonesia	-	0.8	94.3	93.3	0.5	1.3	1.5	1.4
South Korea	0.1	2.2	88.0	85.1	2.4	5.5	7.3	4.3
Thailand	2.4	10.0	91.0	79.7	0.5	2.2	4.1	5.9

Source: WTO (2012).

fully convertible in Nepal except for some specified products as has been laid down by the Government of Nepal; the imports of which are permitted on payment in hard currency. The excise duty levied on goods imported from India and paid for in Indian currency is refunded to the Government of Nepal.

Nepal's central bank (Nepal Rashtra Bank) maintains a list of items that can be imported from India in convertible currency. Currently, 135 items are in the list. Since 1993, the Nepal Rashtra Bank maintains a fixed exchange rate with Indian Rupee (1 INR = 1.6 NPR). When Indian suppliers sell their products to Nepalese importers, Indian excise duty must be paid and should be included in the sale price by the supplier. The rate of excise duty varies widely from product to product. However, if payment is made in hard currency, the goods are exempted from payment of excise duty in India, i.e. the supplier is not to be charged. This was aimed to bring bilateral trade conducted in Indian rupee at par with trade in convertible currency, and was to end the existing mechanism of duty refund procedure, which was cumbersome. This provision provided Nepal a direct control on the customs duty revenues on the imports of manufactured goods from India. It also allowed Indian exports to avail benefit of export promotion schemes prevalent in India, making the products more competitive in Nepal either for sale or for further value- addition. Exports can also be realized in Indian rupees, provided it is through a freely convertible Vostro account.

In 2014, India had extended rupee trade scheme to Iran. Since February 2013, while Iran, on the one hand had started making payments in rupees to Indian exporters, India too paid 45 per cent of its Iran oil bill in Indian rupees through UCO Bank branch in Kolkata. The balance was paid in Euros in Turkey. As per Article 2.53 of the Foreign Trade Policy (2015-2020), "Export proceeds realized in Indian rupees against exports to Iran are permitted to avail export benefits/incentives under the Foreign Trade Policy (2015-20) at par with export proceeds realize in freely convertible currency." A similar payment arrangement was tried with Russia in the past. With experience of rupee trade with Nepal, Russia and Iran, it is imperative for India to assess the effectiveness of rupee trade facility as an instrument of South-South Cooperation, as it would benefit both the parties.

Trade in Local Currency as Instrument of South-South Cooperation

As the payment in local currencies benefit both the parties in minimizing adverse impact of exchange rate fluctuations on export proceeds and help deepen use of those currencies in global foreign exchange markets, countries in the South can cooperate with one another in the framework of South-South Cooperation in smoothening these impacts and contributing to the larger development process. As per RBI (2010)[1], there is some evidence that Indian rupee is accepted in Malaysia, Singapore, Hong Kong, Indonesia, UK and Sri Lanka. In addition, the Task Force[2] recommends that India should aim to target South Asian economies for rupee trade as

India is the largest trade partner in the region and is in a strategic position to manage such an arrangement. Hence, it would be beneficial for India to trade in Indian rupees with its neighbouring countries like Pakistan, Myanmar, Sri Lanka, Bangladesh and Nepal. In fact, the South-South cooperation in finance is already in force in the form of currency swap arrangements. Chaturvedi (2014) provides a succinct analysis of the growing interest among the developing countries for mutually-beenficial currency swap arrangements and other forms of South-South cooperation, and the importance of such modalities of cooperation for promoting trade an dinvestment in the South.

The Task Force also favours India's engagement in rupee trade with developed countries like Australia, Japan, Korea, China, Canada, etc. India is talking with major trading partners, including Singapore and Japan, to accept payment in rupee for a part of their exports. The move may help in making Indian rupee more acceptable in the international trade.[3] Furthermore, India is also keen to extend this scheme to some oil-producing countries such as Angola, Algeria, Nigeria, Oman, Iraq, Venezuela, Qatar, Yemen and Saudi Arabia. Moreover, China has shown interest to initiate yuan-rupee trade, and India is hopeful that Japan too may show an interest in accepting rupee payments.[4] Additionally, the government of India has also signed/extended Currency Swap arrangements with a number of countries, including Japan, Sri Lanka, Bhutan and SAARC nations. The RBI also signed an MoU to consider a currency swap agreement with the central bank UAE (United Arab Emirates). The proposed agreement is aimed to further strengthen close economic relationship between India and UAE.

The above mentioned varieties of engagements between India and other developing countries (even developed countries) show willingness of countries to explore favourable means of mutual trade settlement. Since developing countries face the brunt of currency crises, rupee trade and similar types of schemes in local currency can be employed as an instrument of strengthening South-South Cooperation.

Conclusion

The choice of invoicing currency is important for trade policy-making in the developing countries. Availability of hard currency and cost of commissions and brokerage often affect importing ability of a country, especially the LDC and small economy. In case of low foreign exchange reserve stock, countries have to curtail essential imports including capital goods, which would affect industrialization and impair development process. The severity of exchange rate volatility in many developing countries and LDCs in the past suggests ex-ante policy preparedness to mitigate the exchange rate-induced adjustments in the economy. Trade in the local currency is one of the many ways in which exchange rate risks can be addressed. India's rupee trade scheme with Nepal, Russia and Iran has provided important lessons for designing such payment arrangements for smooth trade between countries in the South. The merits of trade in the local currency and currency swap arrangements are recognized widely now. In that sense, trade in local currency can be an effective instrument for promoting South-South Cooperation among the developing countries and the LDCs.

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Endnotes

1 See Ranjan and Prakash (2010).

2 In 2013, as a combined initiative of the Ministry of Finance and Ministry of Commerce & Industry, the Indian Government formed a Task Force to draw a list of countries with which India could consider doing its trade in Rupees / local currencies. The purpose of the Task Force was to examine various types of arrangements and their implication for India's trade and financial system besides studying the pros and cons of trading in local currency pacts. It also explored the possibility of currency swap agreements between India and identified countries.

3 See Mishra (2013).

4 Government of India considers the proposal to provide a two year extension with amendments to the Framework on Currency Swap Agreement for SAARC member countries up to 14 November 2017 and extension thereafter if necessary.