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Internationalization of Rupee: Discerning the Market Sentiment

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ABSTRACT

To promote global trade in an inexact settlement mechanism experienced by Russia, RBI has allowed the invoicing and settlement of exports/imports in rupee. In the backdrop of the US sanction on the Central Bank of Russia, the move towards INR settlement is not only a timely move to protect the trade transactions with Russia, it is surely a way to explore the market sentiment. The internationalization of a currency requires more trade transactions denominated in that currency. So, with the war and the pandemic-driven fragility in supply chains, the U.S. and its allies' shift towards friend-shoring global trade, move toward INR settlement may have a manifold effects to determine the future settlement of trades among BRICS and other Asian countries.

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1. Background

After the recent circular of the Reserve Bank of India (RBI) on **International Trade Settlement in Indian Rupees (INR),** dated July 11, 2022, the market has started to dwell on the impending future of the Rupee to enhance its dominance in the settlement of the world trade. It may be undoubtedly claimed that RBI's move is a timely move towards stabilizing the disrupted supply chain with Russia and providing INR some relief from being under pressure for increasing demand for USD following Fed's interest rate hike. To promote global trade in an inexact settlement mechanism experienced by Russia, RBI has allowed the invoicing and settlement of exports/ imports in rupee. Most importantly, this step may support the increasing interest of the global trading community in the domestic currency settlement, especially during the time of disruption of the Supply Chain as a Consequence of the Russia-Ukraine war; soaring fuel and commodity prices; appreciation of the Dollar against all the major currency pairs with an explicit move of EUR at Par with Dollar; Recession in the US economy with high inflation and rising interest rate; Expected Recession in the Euro Zone, and the last but not the least Sanction on Russian Central Bank.

2. Ramification in short term and long term: Testing the Market Sentiment

INR settlement has greater ramifications than the promotion of export growth in India. Outwardly, this policy measure is announced with the objective to facilitate trade with Russia, Iran, and Sri Lanka. However, there could be two distinct objectives; 1) short-term – to provide a support to INR against continuous appreciation of Dollar while solving the problem of trade settlement triggered by the qualms due to the war between Russia and Ukraine; 2) long–term goal – providing a message to the world that INR could be an alternative currency for international trade in future and test the market sentiment on the acceptance of INR as a currency of settlement by her trading partner, if not all, at least the BRIC countries and the South Asian countries. Understanding market sentiment about INR as an alternative currency for settlement is extremely important, especially after the event of the sanction imposed on the Central Bank of Russia (RCB) by the US, the European Commission, the UK, France, Germany, and Italy. It may be noted more than 11000 banks across the world are members of the Society for Worldwide Interbank Financial Telecom (SWIFT). So, de-SWIFTed Russian Banks have no other way but to depend on telecom services or fax services for establishing trade transactions with their partners. Consequently, all the trading partners may feel uncomfortable dealing with the Russian banks as there is no way a letter of credit (LC) or bank guarantees (BG) could be established by using the SWIFT platform for any of the export or import transactions. The sanction on the central bank also means that overnight a central bank may find itself debilitated to control the liquidity of the local currency in the local market. Like in Russia, with the sanction the foreign exchange reserves of $600 become illiquid overnight. So, CBR cannot sell the reserves in support to make the rubble stable and the Rubble falls further. Moreover, the dollar NOSTRO fund becomes inaccessible to the Russian banks.

Another important dynamic of the international settlement mechanism is opened with the present global trend of friend-shoring in international trade. With the objective of reducing reliance on Russia and China, the US and its allies are pursuing a new kind of global trade that confines commerce to a circle of trusted nations. It is obvious if there is any cartel formed by the US in terms of the trade in goods and services, it will lead to the breaking of the law of Ricardian comparative advantage theory. Besides the cost of production, it also triggers a discussion on the future of the existing exchange rate mechanism in the international trade settlement.

3. Operational Mechanism

In this section, let us first understand the broken link of the NOSTRO accounts of Russian banks. Suppose, Russia has to make a payment in USD for any goods purchased from India and the invoice is in USD 5 million for spot settlement. Russian banks will debit its NOSTRO account kept with say, Citi bank New York to make the payment. If the exporter's bank is SBI then SBI's NOSTRO account gets credited by 5 million USD and against this receivable SBI will convert the USD into INR using the market rate and will credit the customer account in India in INR. Due to imposed sanctions on SWIFT transactions and forex reserve usage, this mechanism becomes ineffective. Consequently, invoicing and using INR as a settlement currency will definitely help the trade run between India and Russia. In such case settlement has to work through Rupee VOSTRO account. Since 2016, as per the Regulation 7(1) of Foreign Exchange Management (Deposit) Regulations, Authorized Dealers (AD) banks in India are allowed to open Rupee Vostro accounts of correspondent bank/s of the partner trading country

a. Indian importers undertaking imports through this mechanism shall make payment in INR which shall be credited into the Special Vostro account of the correspondent bank of the partner country, against the invoices for the supply of goods or services from the overseas seller /supplier.

b. Indian exporters, undertaking exports of goods and services through this mechanism, shall be paid the export proceeds in INR from the balances in the designated Special Vostro account of the correspondent bank of the partner country.

The bank of a partner country may approach an AD bank in India for the opening of Special Rupee VOSTRO account. The AD bank has to seek approval from the Reserve Bank of India with details of the arrangement. AD bank maintaining the special Vostro Account has to ensure that the correspondent bank is not from a country or jurisdiction in the updated Financial Action Task Force (FATF) Public Statement on High Risk & Non-Co-operative Jurisdictions on which FATF has called for counter measures. It may be noted that a similar settlement mechanism was used previously for trade with IRAN. Two Indian banks opened the VOSTRO accounts and later on those accounts dried up. Following the rules of the US Office of Foreign Assets Control (OFAC) India had to reduce its import bill. Consequently, India did not have sufficient rupee to deposit in this account. It may be well noted that the entire process of INR settlement in the present form has to follow a special approval route from RBI. Also, import and export transaction has to fulfill all the documentary compliances under Uniform Customs & Practice for Documentary Credits (UCP 600) and International Standard Banking Practices (ISBP) for LC transactions and Uniform Rules for Bank Guarantees (URDG 758) for transactions with Bank Guarantees (BGs).

Most importantly, if an overseas buyer has both receivables and payables then 'set-off' of export receivables against import payables through the Rupee Payment Mechanism may be allowed. Indian exporters are allowed to receive advance payment in Indian rupees against exports made to overseas importers through the above Rupee Payment Mechanism. However, Indian banks have to ensure that the available funds in the VOSTRO accounts are first used for all the import payments, and then the remaining fund will be allowed for the advance payment to the Indian exporter. Besides following all due diligence, releasing funds to the Indian exporter is subject to the verification of the claim of the exporter by the Indian banks holding the special VOSTRO accounts. The advance payment to the Indian exporter is also subject to the advice received from the correspondent bank overseas along with an instruction of the overseas importer. Other than providing advance payment to the Indian exporter, the remaining fund may also be used for: a) Payments for projects and investments, b) Investment in Government Treasury Bills, Government securities, etc. in terms of extant guidelines and prescribed limits, subject to FEMA and similar statutory provision. As India already has USD 6.6 billion with Russia (India's import from Russia is more than its export), Russia has two options; 1) hold the fund in an INR VOSTRO account which will not help them earn any return, 2) invest in government securities. As because keeping the Rupee fund idle, the yearly depreciation cost could be even 3-4%, it would be wise to get the excess fund invested in government securities.

4. Future Horizon

RBIs move for INR settlement is well appreciated as it helps in promoting the growth of global trade with emphasis on exports from India and supports the increasing interest of the global trading community in INR. Primarily, the INR settlement will help India to keep the flow of international trade transactions floating and overcome the block of the US sanction on Russia. Importantly, market sentiment for INR settlements is to be discerned from the present condition. It is true that the internationalization of a currency requires more trade transactions denominated in that currency, however, it takes time. So, with the war and the pandemic-driven fragility in supply chains, the U.S. and its allies' shift towards friend-shoring global trade, move toward INR settlement may have a manifold effects to determine the future settlement of trades among BRICS and other Asian countries. If the Asian countries are also forced to move towards friend-shoring trade transactions we may experience a completely new prospect in international trade settlement in the coming days.

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