



Reserve Bank of India

Country Paper¹

Local Currency Settlement (LCS) in the Context of India: Practices, Challenges and Prospects

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'Trading in Local Currencies: Problems and Prospects for the SAARC
Countries'
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Introduction

The outsized role of the US dollar has been a prominent feature of the global financial landscape over the decades. The sustained leading position of the US in the world order, the dominant use of the US dollar for trade invoicing and cross-border investments and the preferred choice of USD as an exchange rate anchor have strengthened the position of USD. According to the Dominant Currency Paradigm², the ‘dominant currency’ position of USD led to higher inflation sensitivity to exchange rate fluctuations and high spill over to the partnering economies. Post the Global Financial Crisis, China promoted internationalisation of the Chinese Yuan (CNY) through various bilateral swap arrangements and encouraged trade settlement in CNY. The inclusion of the Chinese renminbi (RMB) in the IMF’s Special Drawing Right (SDR) basket of currencies in 2016 had provided fillip to their efforts. In most recent years, economic fragmentation and the potential reorganization of global economic and financial activity into separate, non-overlapping blocs could encourage some countries to use and hold other international and reserve currencies (Source: IMF³).

The data provides a mixed scenario. The dominance of the USD remains intact in global trade since even the non-USD currency pairs are exchanged not directly but via the dollar route. Approximately half of global trade is invoiced in the USD and USD is used in nearly 90 per cent of global foreign exchange (FX) transactions (Source: *BIS Quarterly review December 2022*). According to SWIFT, USD accounts for over 80 percent of trade finance. However, there has been a definitive downward trend in the share of the US dollar as part of global foreign exchange reserves, which has declined substantially from a peak of 72.5 per cent in 2002 to less than 60 per cent in 2023 (Chart 1).

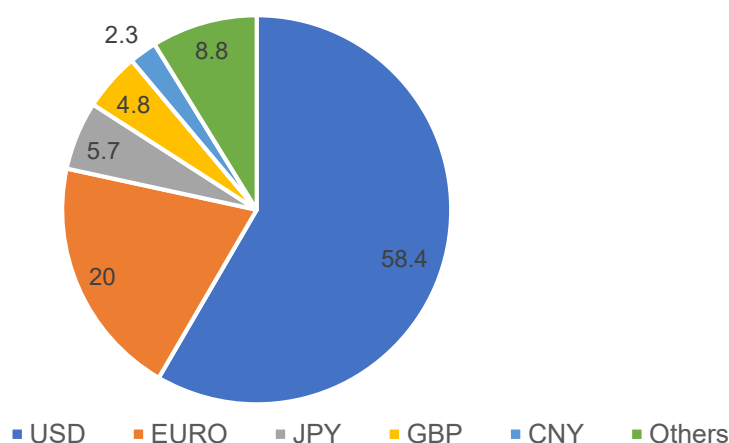
The steadily decreasing share of USD in foreign exchange reserves of countries, the backdrop of efforts to increase usage of other currencies in trade invoicing and settlement, the emergence of various bilateral and regional economic cooperation agreements and the recent geopolitical developments, have set the stage for the

² Dominant Currency Paradigm’ by Gita Gopinath, Emine Boz, Camila Casas, Federico J. Díez, Pierre-Olivier Gourinchas and Mikkel Plagborg-Møller. *American Economic Review*, Vol. 110, NO. 3, March 2020. (pp. 677–719)

³ <https://www.imf.org/en/Blogs/Articles/2024/06/11/dollar-dominance-in-the-international-reserve-system-an-update>

emergence of various other currencies as prospective currencies for use in international transactions.

Chart 1: Forex Reserve by Currency:Q4 2023 (per cent)



Source: International Monetary Fund (IMF)

An IMF study in 2024⁴ has confirmed that a very gradual shift from the USD and an increasing play of non-traditional currencies of small, open, well-managed economies, facilitated by new digital trading technologies, are likely to continue with evolving the international monetary and reserve system. At this juncture, Indian Rupee (INR) holds a key promise.

India's external sector has shown remarkable progress in the last three decades after the economic liberalisation reforms were set in motion. Over the years, linkages of the Indian economy with the rest of the world in terms of trade and capital flows have increased. In the last decade, India's foreign exchange reserves have grown from USD 290.5 billion in August 2012 to USD 560.4 billion in August 2022. During this decadal period, India's Foreign Direct Investment (FDI) has increased from USD 46.6 billion to USD 84.8 billion; imports have increased from USD 489.3 billion to USD 612.6 billion, and exports have grown from USD 306.0 billion to USD 421.9 billion. In the post pandemic time, most of the macroeconomic parameters of India showed a robust performance, viz. higher GDP growth, moderating inflation, stable financial sector and

⁴ <https://www.imf.org/en/Blogs/Articles/2024/06/11/dollar-dominance-in-the-international-reserve-system-an-update>

resilient external sector. Looking ahead, the conditions seem opportune for the emergence of INR as an international currency.

The Reserve Bank of India (RBI) constituted an Inter-Departmental Group (IDG) on Internationalisation of Indian Rupee in December 2021 and the committee gave its recommendations in October 2022. The recommendations were segregated in short-term, medium- and long-term time horizon for implementation. One of the key recommendations by the IDG has been the use of local currencies in trade settlement. The IDG has also observed that the Local Currency Settlement (LCS) framework would facilitate wider use of local currencies in current and capital account transactions thereby facilitating the ease of doing business and reducing dependence on hard currencies. The IDG has also recommended that the use of local currency in trade settlement needs to be supported by measures like liquidity arrangements, through bilateral swaps between central banks and improved access for investment in domestic markets. The RBI's signing of the Memorandum of Understanding (MoU) with the Central Bank of UAE in 2023 and Bank Indonesia in 2024 for settlement of bilateral transactions under the LCS Scheme are fructifications in this direction. The RBI is currently in discussions with a few more countries for such MoUs.

Settlement of in Local Currency Settlement System: Need and Relevance

The local currency settlement would primarily allow the country's exporters and importers to limit exchange rate risk. Invoicing and settling of international trade transactions in INR with trade partners with whom India has a trade deficit will generally reduce the current account deficit denominated in convertible currencies. Commensurately, there will be a reduced need to maintain large foreign exchange reserves in convertible currencies. So, for India, there is considerable merit in expanding the use of local currencies, particularly with large trading partners.

In the case of the SAARC region, all SAARC countries have high trade relations and consistent trade deficit with India. Bhutan and Nepal recorded around 62 percent and 75 percent of their total trade with India in 2022. India also holds share of more than 25 percent in Sri Lanka's and 15 percent in Bangladesh's total imports (Table 1).

Table 1: Share of India in total trade of SAARC countries (percent)

| No. | Countries | Exports | Imports | Total Trade |
|-----|-------------|---------|---------|-------------|
| 1 | Afghanistan | 44.93 | 9.59 | 13.19 |
| 2 | Bangladesh | 3.65 | 15.98 | 11.42 |
| 3 | Bhutan | 39.62 | 88.75 | 75.62 |
| 4 | Maldives | 4.05 | 14.12 | 13.68 |
| 5 | Nepal | 63.30 | 62.00 | 62.13 |
| 6 | Pakistan | 0.00 | 0.39 | 0.27 |
| 7 | Sri Lanka | 5.35 | 25.78 | 15.83 |

Source: Source: International Monetary Fund (IMF); Data for the year 2022.

As per 2022 data, the forex reserves of Bangladesh, Bhutan, Pakistan, and Maldives are insufficient to cover the trade deficit, exposing these countries to external shocks and vulnerabilities (Table 2). Additionally, countries like Sri Lanka faced serious economic crises during post-pandemic times which largely emanated from forex liquidity pressures. Shifting to a local currency settlement would help these countries reduce the need to maintain large foreign exchange reserves in USD and thus lower USD liquidity pressures.

Table 2: Comfort of forex reserve to cover trade deficit in case of SAARC countries

| Countries | Export (USD million) | Import (USD million) | Trade deficit (USD billion) | Forex data (USD billion) | Comfort of forex reserve to cover trade deficit |
|-------------|----------------------|----------------------|-----------------------------|--------------------------|---|
| Afghanistan | 511.54 | 4,512.80 | 4.00 | 9.75 | Yes |
| Bangladesh | 47,085.87 | 80,161.53 | 33.08 | 25.2 | No |
| Bhutan | 1,495.21 | 4,102.12 | 2.61 | 0.53 | No |
| Maldives | 159.01 | 3,515.66 | 3.36 | 0.59 | No |
| Nepal | 1,477.68 | 14,011.94 | 12.53 | 13.2 | Yes |
| Pakistan | 30,872.79 | 70,687.43 | 39.81 | 12.4 | No |
| Sri Lanka | 17,044.51 | 17,945.63 | 0.90 | 4.5 | Yes |

Sources: International Monetary Fund (IMF) and Central Bank Websites;

Trade data are for the latest year 2022 available on IMF DOTS; forex data for end Feb/March 2024 barring Bhutan and Afghanistan: forex data for Bhutan for end December 2023 and for Afghanistan for end 2020.

In view of the above, the local currency settlement of trade among SAARC countries holds merit and any concerted efforts in this direction would be beneficial to SAARC region in the long run.

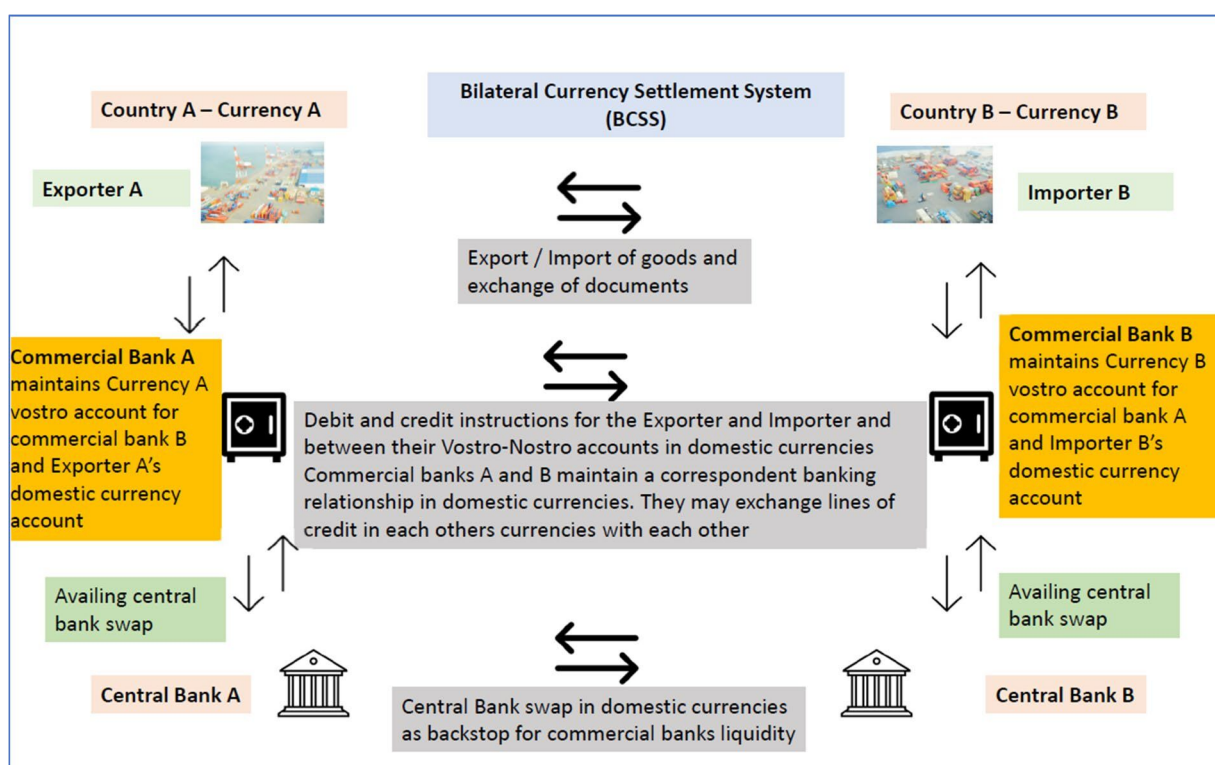
Current Landscape of Local Currency Settlements in India

The Reserve Bank of India (RBI) has signed MoUs with the Central Bank of UAE (on July 15, 2023) and Bank Indonesia (on March 07, 2024) to establish a Framework to Promote the Use of respective Local Currencies for cross-border transactions. RBI is also in the advanced stages of signing such MoUs with many other countries in the near future. Before going forward on this, we may revisit the features of this mechanism.

Salient Features of the Mechanism under the (LCS) MoU

- The mechanism will use the two countries' existing banking systems and correspondent banking relationships.
- Banks in both countries shall facilitate the settlement of transactions in respective local currencies without requiring their conversion into third currency/ies.
- The exchange rate will be market-determined.
- All current account transactions (including all trade transactions like oil) and permissible capital account transactions will be part of the mechanism.
- All the exporters and importers have a choice to pay for their transactions in local currencies (like AED/Rupiah or INR) based on their commercial judgment and mutual agreement.

Chart 2: Operational details of LCSS framework



While presently, the transactions will be done through banks in both countries using the existing SWIFT messaging system and national payment systems in the respective countries, with the integration of the national digital payments' platforms in the near future, the transactions may be routed through alternative messaging platforms and processed in a more timely and cost-efficient manner

A local currency settlement provides currency diversification that stabilises the local currency and provides a natural hedge for the business community to protect against currency risk exposure, reduces transaction costs through more efficient direct rates, and facilitates faster transfers. The LCS framework follows a comprehensive approach as it attempts to expansively cover issues inter alia relating to the establishment of correspondent banking relationships in local currencies, the use of national payment systems, the requirement for bilateral domestic currency swaps, hedging, etc. The Inter-Departmental Working Group (IDG) of RBI suggested that a common template can be adopted while entering into such an arrangement with the partner countries. Subsequently, a local currency swap arrangement can be explored to supplement the LCS arrangement and its emergent liquidity requirements. Local currency swaps that allow central banks to exchange domestic currencies with each other are important tools for reducing/managing financial risks. Encouraging the

international usage of the INR requires that after a certain threshold level of settlement of bilateral transactions is achieved in INR, sufficient liquidity in INR is available at government to government/central bank to central bank level. Hedging may be operationally challenging for all the stakeholders while adhering to two different regimes and the position may become more complex in case more such bilateral arrangements are entered into in the future. However, it is felt that to the extent possible, these differences may be narrowed down. Accordingly, users in each country may be permitted to hedge their exposures as per the regulatory regime in place in that country, with only the incremental permissions/prohibitions being stipulated. This approach will allow the market to take up the local currency settlement without much difficulty. It will also help in simplifying the framework and minimise the need for future changes.

The establishment of a Local Currency Settlement System between India and the other corresponding countries is a transformative step in bilateral relations, poised to boost trade and economic cooperation while reducing dependency on third-party currencies. However, its success hinges on the effective management of potential challenges and ensuring balanced benefits for both parties.

The Reserve Bank of India has undertaken various measures in recent years for promoting local currency trade settlements and for achieving the broader long-term goal of Internationalisation of INR. Some of these measures are enlisted below:

- The RBI constituted an Inter-Departmental Group on the Internationalisation of Indian Rupee in December 2021 (Chairman: Mr. R.S. Ratho, Executive Director, RBI). The committee gave its recommendations in October 2022. The recommendations were segregated into short-term, medium and long-term time horizon for implementation.
- Gujarat International Finance Tec-City (GIFT City), Gandhinagar was set up as India's first International Financial Service Centre (IFSC) with a vision to bring to the Indian shores the financial services/markets and transactions, relating to India, that are currently done off-shore. The GIFT IFSC has the potential to develop as a competitor to international financial centres for INR products and more specifically INR derivatives, given the fact that the Rupee derivatives are among the most traded contracts globally. To cater to the global demand for Rupee products, non-

deliverable OTC and exchange-traded Rupee derivatives are now allowed at the GIFT IFSC. It also provides an opportunity for Indian entities to raise foreign capital through masala bonds and list the same on the exchanges in the IFSC.

- **Use of local currencies in Asian Clearing Union (ACU):** The RBI proposed the use of local currencies of members for settlement of ACU transactions. The proposal is presently under examination.
- **Signing of Memorandum of Understanding (MoU):** India signed MoUs with Central Bank of UAE for settlement of bilateral transactions in respective currencies under Local Currency Settlement Scheme (LCSS) in July 2023 and with Bank Indonesia (BI) in March 2024. The RBI is in discussions with a few other countries for similar MoUs.
- **INR as a Designated Foreign Currency in Sri Lanka:** In August 2022, Sri Lanka made the INR a designated foreign currency. This paved the way for INR-based bilateral trade between Sri Lanka and India.
- **RBI's July 11, 2022 circular on International Trade Settlement in Indian Rupees (INR):** The mechanism introduced in July 2022 is an additional arrangement for denominating, invoicing, and effecting payment and settlement of exports/imports in the INR and coexists with the current practice of trade payment and settlement in freely convertible foreign exchange. Accordingly, for settlement of trade transactions with any country, an AD bank in India may open Special Rupee Vostro Accounts of correspondent bank/s of the partner trading country⁵.
- **Use of Indian Payment Infrastructure:** Initiatives are being taken to interlink fast payment systems operating across jurisdictions to facilitate cross-border payments and remittances. India has interlinked the UPI with Singapore's PayNow. Further, the RBI in collaboration with the Government of India (GoI) and the National Payments Corporation of India (NPCI) is reaching out to jurisdictions to increase the global outreach of the UPI to facilitate cross-border transactions, including

⁵In order to allow settlement of international trade transactions through this arrangement, it has been decided that: 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. 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.

remittances. The linkages between fast payment systems across jurisdictions can enhance cross-border payment arrangements and ensure faster remittances.

- On December 21, 2023, a significant step was taken towards promoting the Internationalisation of the INR and supporting local currency settlements with partner countries through the issuance of Foreign Exchange Management (Manner of Receipt and Payment) Regulations, 2023. The rationalised regulations, inter alia, include the following major amendments:
 - The extant regulations allowed receipt/ payment in foreign currency only for freely convertible currencies. The revised regulations enable receipt/payment in any foreign currency, which would aid in local currency settlement with the partner countries; and
 - The earlier regulations allowed receipt/ payment in INR for all cross-border transactions (current as well as capital) for non-ACU countries, whereas such receipt/payment was not allowed in respect of some ACU countries (viz., Bangladesh, Myanmar, Pakistan and Maldives). The revised regulations now enable INR settlement for all ACU countries for non-trade related transactions, and for trade related transactions in accordance with the Directions issued by the Reserve Bank from time to time.
- The regime for FPI investment in debt has been evolving within the broader context of the calibrated opening of India's capital account to external debt flows. Two new channels, viz., the Voluntary Retention Route (VRR) and Fully Access Route (FAR) were introduced in addition to the Medium-Term Framework (MTF) for investment by non-residents in the domestic debt markets. Each channel is designed to cater to non-residents with different investment philosophies. Following these reforms, J P Morgan and Bloomberg announced inclusion of the Indian government bonds in their emerging markets suite of indices with effect from June 2024 and January 2025, respectively.
- RBI has announced the following key priority agenda for 2024-25 which would facilitate trade settlements and the Internationalisation of INR:
 - Non-residents to be allowed to open INR accounts only with the overseas branches of Authorised Dealers (ADs) for the purpose of

undertaking current and capital account transactions permitted under the FEMA, 1999. Creating a mechanism for providing INR finance from the Indian banking system to non-residents other than NRI/Overseas Citizens of India (OCIs); and Recalibrating the regime for Foreign Portfolio Investment (FPI) in debt.

Issues and Challenges

- While negotiating swap lines in soft currencies, the challenge of exploring avenues for investments of surplus Local Currencies (LCYs) in the country of issuance has to be addressed. A suitable examination of the avenues, based on the mutual consent of both countries, has to be undertaken.
- For determining the exchange rate for conversion of cross currencies, direct quotes may not be available. Initially, the exchange rate with reference to the USD or another third currency may need to be referred to for determining the external value of the currency. Over a period of time, as the market develops and turnover reaches a certain threshold, direct quotes would also become available.
- Suitable cross-border payment mechanisms leveraging on domestic payment systems like UPI/RTGS/Indigenous card networks need to be devised which may need considerable time for exploration and development.
- Financial messaging across borders is excessively dependent on the SWIFT messaging system. We may need to consider an alternative messaging system that is equally safe and secure. RBI is in the process of developing a global SFMS hub towards this end.
- Local currencies usually have limited liquidity compared to hard currencies. This can make it challenging to execute large transactions without significantly affecting the exchange rate.
- Considering the conventional usage and historical preferences of hard currencies, there may be initial challenges in the adoption of LCS-based transactions by respective commercial banks as well as local traders. However, in the long run, the comparative advantages of resorting to local currencies for settlement of cross-border transactions may give fillip to this mechanism.

Prospects and Way Forward

The prospects for a Local Currency Settlement (LCS) system are encouraging especially in the background of changing global dynamics particularly as countries are striving to reduce their dependence on major global currencies and thereby enhancing their economic sovereignty. Local Currency Settlement systems can reduce transaction costs associated with currency conversion, foreign exchange fees, and the risks of exchange rate fluctuations. Local currency settlements can also boost regional trade by making transactions smoother and in time efficient manner, thus fostering closer economic ties.

The seamless implementation of LCSS requires a coordinated approach among multiple dimensions including regulatory harmonisation. Here are some steps to facilitate the way forward:

- Going forward, the LCS mechanism can be leveraged with efficient, secure, and interoperable payment systems to facilitate seamless transactions in local currencies.
- Modern technologies such as central bank digital currencies can be leveraged to enhance the efficiency and security of the settlement system.
- Interbank networks or financial messaging systems can be strengthened to facilitate seamless local currency settlements across different financial institution
- A comprehensive risk management strategy may be developed to address potential risks such as currency volatility, liquidity issues, and cybersecurity threats.
- Suitable financial products denominated in local currency can also be developed to support various types of transactions, including trade finance and investment.

The adoption of LCS systems holds significant potential for enhancing economic resilience and fostering regional integration. Success depends on building robust financial infrastructure, ensuring regulatory alignment, and fostering trust and confidence in local currencies. By addressing these challenges and leveraging technological advancements, countries can create a conducive environment for the widespread use of local currency settlements, ultimately contributing to a more stable and diversified global financial system.

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