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International Trade Settlement Mechanism in the Indian Rupee: Benefits and Implications

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Summary

The introduction of an international trade settlement mechanism in the Indian Rupee (INR) will expand India's trade with countries facing shortage of the American dollar. It can also arrest the slide in the value of the INR against the United States dollar and pave the way for the INR's acceptance as a global currency.

The Reserve Bank of India (RBI) has recently announced an international trade settlement mechanism in the Indian Rupee (INR). The mechanism will enable the invoicing of exports and imports in the INR. It will involve setting up the INR Vostro accounts by authorised Indian banks and their corresponding banks in partner countries. Indian importers will pay for imports in the INR that will then be credited into these accounts. Indian exporters, on the other hand, will receive payments from these accounts.

The core objective of the mechanism is to reduce the invoicing of trade in United States (US) dollar by shifting to the INR. Such shifting will make it much easier for Indian exporters and importers to trade with countries facing difficulties in invoicing trade in the US dollar. These include countries like Russia and Iran. Due to prevailing Western sanctions, traders from these countries find it tough to mobilise the US dollar for invoicing exports and imports. An arrangement enabling the pricing of trade in the INR will overcome these difficulties and accelerate their trade with India.

Difficulties in mobilising the US dollar are affecting the trade prospects of several countries which face acute foreign exchange shortages. Traders from several parts of Africa, South America and Asia are unable to mobilise the US dollar for invoicing. The problem of mobilising the US dollar affects trades between these countries and the rest of the world. If these countries are willing to invoice exports and imports trade in the INR, it will brighten the prospects of their bilateral trade with India.

The settlement mechanism was announced when the Indian currency depreciated sharply against the US dollar. The INR is currently pegged at almost ₹80 to US$1, compared with a value of less than ₹75 about a year ago. The unprecedented low value of the INR has made India's imports expensive. Though India has been able to avoid some of the impact of a declining INR on energy imports by buying crude oil from Russia, the overall impact on the import basket has been unavoidable.

At the end of May 2022, India's overall imports valued in US dollars showed a growth of 62.9 per cent vis-à-vis May 2021. This was lower than the growth of 71.9 per cent estimated in the INR for the same period. The difference underlines the widening gap between the INR and the US dollar and the declining purchasing power of the former.

If more of India's external trade gets invoiced in the INR, then the internal demand for the US dollar would decrease, reducing the price of the US dollar against the INR. The INR settlement mechanism can certainly be of help in this regard. Interestingly, the mechanism comes soon after the US Federal Reserve raised interest rates by 0.75 percentage basis points in June 2022 – the largest such increase in almost four decades.

Successive interest rate hikes by the US Federal Reserve to tackle inflation have led portfolio investors across the world to invest more in US securities as these now promise higher yields. India has felt the impact of the global capital reallocation with the supply of the US dollar decreasing in the economy following outflows of foreign portfolio investment. Lesser US dollars in the economy have made them dearer against the INR, making the US dollar more expensive.

With global inflation unlike to abet, given the prolongation of the Russia-Ukraine conflict and its impact on global food and energy prices, US interest rates should remain firm. The US dollar will also strengthen further, leading to the weakening if the INR. The situation justifies policies encouraging lesser use of the US dollar. It is hardly surprising, therefore, that Indian exporters have enthusiastically greeted the announcement by the RBI.

A transparent and efficient framework for conducting international trade transactions in the INR will also pave the way for the INR's acceptance as a global currency. India's new free trade agreements (FTA) – both concluded (United Arab Emirates and Australia) and upcoming (Canada, European Union and the United Kingdom) – should comprehensively increase its varied economic engagement with the FTA partner markets. A pre-existing international settlement mechanism for the INR will facilitate this engagement. Indian banks and their foreign counterparts can be prepared to settle trade transactions in the INR by the time the FTAs pick up momentum. This would help accept the INR as a currency of choice for trade among India's major economic partners and its recognition as a global currency.

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