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TRADING IN LOCAL CURRENCIES:

PROBLEMS AND PROSPECTS FOR THE SAARC COUNTRIES

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1. Introduction:

The South Asian Association for Regional Cooperation (SAARC) countries, comprising Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka, represent a diverse and economically significant region. With a collective population exceeding 1.9 billion, this region is marked by varying stages of economic development, literacy rates, inflationary pressures, and trade dynamics. As of 2023, the combined GDP of the SAARC countries stands at approximately $4.5 trillion, with India contributing the largest share, followed by Bangladesh and Pakistan.

Inflation rates across the region have been a point of concern, particularly in countries like Bangladesh, and Pakistan where inflation has surged to double digits, exacerbating economic challenges. In contrast, nations like Bhutan, Maldives and Sri Lanka have managed to maintain relatively lower inflation levels, although they face their own set of economic hurdles. The literacy rates also vary significantly, with countries like Sri Lanka boasting a literacy rate of over 90%, while Afghanistan struggles with a rate below 40%, reflecting the disparities in human capital development within the region.

These nations, while sharing geographic proximity, exhibit wide disparities in economic development, trade practices, and financial stability. In recent years, the concept of trading in local currencies has gained traction as a potential means to shore up regional trade, reduce dependence on global currencies like the US dollar, and enhance economic cooperation.

Trade within the SAARC region remains limited, with intra-regional trade accounting for only about 5% of the total trade of these countries. This low level of economic integration has prompted discussions on the potential benefits of trading in local currencies, bypassing the reliance on major global currencies like the US dollar. Such a move could help mitigate the exchange rate volatility that has historically plagued many SAARC nations, leading to more stable and predictable trade relations.

This article delves into the challenges and prospects of trading in local currencies within the SAARC region, examining the economic, financial, and institutional factors that could influence this shift. It also highlights the experiences of countries, which have taken initial steps towards local currency trade, offering valuable insights for the broader region.

2.1 Bangladesh

A. Background

US dollar (USD) plays the dominant role as an invoicing currency in global trade. Roughly 40 percent of international trade transactions in goods are invoiced in dollars, whilethe US share of global trade is only 10 percent (Gopinath et al., 2020). However, geopolitical tensions and US sanctions have driven countries like Russia, Iran, and Venezuela to seek alternatives, such as bilateral local currency settlements. China's RMB has gained prominence through extensive bilateral swap agreements, indicating a potential shift towards multilateral use, with significant implications for SAARC countries.

Local currency always preferred. But not possible, Why?

Trading in local currencies offers simplicity and cost-effectiveness but faces several barriers to widespread adoption. Issues include limited currency convertibility, regulatory constraints, and market acceptance concerns. Not all currencies are freely convertible, and exchange rate fluctuations can introduce risks. Regulatory barriers related to foreign exchange controls and trade finance can complicate local currency use. Limited acceptance of local currencies in international markets and the preference for widely recognized currencies by trade partners also pose challenges. Additionally, countries with trade surpluses often accumulate foreign reserves in widely accepted currencies rather than less convertible local currencies.

Factors important for successful local currency trade

- Strength of currencies: Ensuring the convertibility of local currencies is vital for promoting their use in international trade. Countries need to liberalize their exchange rate regimes and reduce restrictions on currency conversion to facilitate the seamless exchange of local currencies in trade transactions.
- Reciprocity and compatibility of the financial infrastructure: Developing robust financial infrastructure, including payment systems, clearing mechanisms, and settlement platforms, is critical for facilitating local currency trade. Investments in modernizing financial infrastructure are necessary to support the efficient settlement of international trade deals in local currencies.
- Market access and confidence: Building trust and confidence among traders, businesses, and investors in the stability and reliability of local currencies is essential for promoting their use in trade transactions. Central banks and governments need to implement sound monetary and fiscal policies to maintain currency stability and minimize exchange rate risks.
- Regulatory Framework: Establishing clear and supportive regulatory frameworks is essential for promoting local currency trade. Governments need to implement policies that facilitate currency convertibility, remove barriers to trade settlement in local currencies, and provide legal certainty for businesses engaging in such transactions.

B. Objectives

The objective of this paper is to look into ways to promote foreign trade settlements denominated in local currencies among SAARC countries. Exploring the potentials of local currency trade across SAARC countries unveils promising avenues for enhancing economic collaboration and integration within the region. By embracing local currencies for trade settlements, SAARC nations can mitigate reliance on external currencies, thereby reducing susceptibility to exchange rate fluctuations and external economic shocks. This shift towards local currency trade holds the potential to streamline cross-border transactions, fostering greater efficiency and cost-effectiveness for businesses operating within the region. Moreover, promoting local currency trade can bolster financial inclusion, particularly among underserved populations, by facilitating access to financial services and promoting economic participation. The exploration of local currency trade within the SAARC framework not only strengthens regional economic ties but also lays the foundation for sustainable development and shared prosperity across member countries.

C. Current practices in local currency trade

The US Dollar has long dominated global trade and financial transactions, comprising nearly 90% of OTC foreign exchange turnover and about 80% of export invoicing. Although its usage dipped from 89.9% in 2001 to 84.9% in 2010, it rebounded to 87.6% in 2016. Conversely, major currencies like the Euro, Yen, and Australian Dollar have experienced declines in market share. Meanwhile, emerging market currencies, notably the Chinese Renminbi (RMB), have made gains. The RMB's share doubled from 2.2% in 2013 to 4% in 2016, advancing from the 9thto the 8th position globally, largely due to increased trading against the USD. Similarly, the Indian Rupee expanded its market share from 0.2% in 2001 to 1.1% in 2016, despite a slight decrease in its global ranking from 15th in 2010 to 18th in 2016.

Regional Arrangements

Intra-regional Trade in South Asia

The SAARC forum was established to accelerate economic and social development among South Asian countries, later focusing on trade promotion. Despite efforts like the SAARC Preferential Trading Agreement (SAPTA) and the South Asian Free Trade Area (SAFTA), intra-regional trade within SAARC remains low compared to other regional groups like ASEAN. In 2008, intra-SAARC trade accounted for just 4.8% of the region's total foreign trade, with larger economies like India and Pakistan not viewing smaller SAARC nations as significant export markets. However, there has been notable growth in India's trade with other SAARC countries, especially with Pakistan and Sri Lanka. Addressing economic disparities and fostering closer integration are crucial for enhancing intra-regional trade within SAARC.

An ASEAN Highlights

Research by ASEAN and partners reveals that the Thai baht's use in exports, particularly within intra-ASEAN trade, is growing but remains limited, representing less than 7% of export invoices. The U.S. dollar dominates Thailand's international trade, especially with the U.S., while the Euro's usage is tied to increased trade with the Euro area, accounting for about 5% of invoicing. The decline in Thai baht usage from 2001-2008 contrasts with the rising use of the Euro as a vehicle currency.

Experience of Singapore

The case study on Singapore shows that while the U.S. dollar is predominantly used for trade settlements, the yen and Singapore dollar are also accepted to a lesser extent. Currency choice is influenced by factors such as transaction costs, supplier preferences, and accounting ease, though enthusiasm for using local currencies is tempered by concerns over liquidity and implementation challenges.

The experiences of NAFTA and EU

The experiences of the North American Free Trade Agreement (NAFTA) and EU countries in currency invoicing practices offer valuable insights into the challenges and opportunities for East and Southeast Asia's regional trade and monetary integration. In North America, market forces have largely driven economic integration, with the US dollar serving as the dominant currency for trade transactions. Conversely, European economic integration has been a staged process, guided by a political vision of creating a single market and enhancing Europe's global monetary role. The creation of the Euro was a significant milestone in strengthening Europe's position within the global monetary system.

ASEAN local currency cross-border payments in a multilateral setting

The May 2023 ASEAN Summit in Indonesia prioritized regional connectivity and local currency transactions, leading to the development of a Local Currency Transactions Framework. Building on the Local Currency Settlement Framework (LCSF) established by Thailand and Malaysia in 2016, recent initiatives include a QR-code-based payment system by central banks in Indonesia, Malaysia, Singapore, and Thailand to facilitate direct local currency exchanges and boost financial inclusion.

The BRICS local currency payment project

The August 2023 BRICS Summit in Johannesburg focused on expanding the use of local currencies for cross-border transactions, supported by initiatives like BRICS Pay and plans to integrate six new members. This shift towards financial autonomy includes leveraging digital currencies like the RMB to enhance international monetary infrastructure within the BRICS bloc.

Bilateral Movement with Local Currency Trade

China's RMB has gained prominence in bilateral cross-border payments, driven by currency swap agreements with 41 countries totaling 3.5 trillion yuan and surpassing the USD in nearly half of China's cross-border transactions. RMB usage in global payments has risen significantly, with a median increase from 0% in 2014 to 20% in 2021, and reaching 70% in some economies. Key developments include potential multilateral RMB use and the mBridge project, which aims to facilitate cross-border payments using digital currencies. Meanwhile, India is promoting the INR for cross-border payments, including trade settlements with the UAE and SAARC countries, and is expanding its efforts with initiatives like the Asian Clearing Union and Special Vostro Rupee Accounts (SVRCs) for banks from 22 countries.

Russia forced by sanctions to use the RMB

After sanctions from the Russia-Ukraine war, Russia increased reliance on RMB and Rubles for trade with China and shifted to using RMB and UAE dirham for oil payments with India. Additionally, Russia mandated "unfriendly" countries to pay for gas in Rubles, boosting Ruble demand but not fully bypassing the USD in cross-border transactions.

China-Nigeria Alliance

China's efforts to expand RMB usage in cross-border payments led Nigeria's Central Bank to shift from the US dollar to the RMB in 2016, following a currency swap deal. This move, driven by the desire to reduce dollar dominance and stabilize the Naira, boosted China-Nigeria trade, which had previously declined due to dollar settlement risks. Nigeria's adoption of the RMB has influenced other African nations, reinforcing the RMB's role as an international currency in Africa and challenging the dollar's dominance.

The status and influence of the RMB in Africa

Chinese-funded banks have expanded across Africa, with institutions like the Sino-Congolese Bank and multiple Bank of China branches, while African countries integrate the RMB into foreign reserves and bond markets. This growing RMB adoption by African enterprises highlights its benefits in cost savings and risk reduction, driving the RMB's internationalization.

Trade in Local Currency in SAARC

SAARC nations aim to increase currency swaps to bolster foreign exchange reserves and economic recovery, yet intraregional trade remains low at 5% compared to ASEAN's 25%. Utilizing local currencies in trade could reduce exchange rate risks and enhance cooperation among Global South countries for broader development.

Experience of the Rupee trade scheme by India

India has piloted local currency trade arrangements, such as the rupee trade scheme, with countries like Nepal, Russia, Iran, and Bangladesh, allowing for settlement in Indian rupees (INR) to boost bilateral trade. These efforts include extending such schemes to other SAARC countries and beyond, with notable cases in Malaysia, Singapore, and Sri Lanka. India is also pursuing trade in its local currency with nations including Australia, Japan, and China, and has implemented currency swap agreements with several countries. These initiatives aim to reduce reliance on traditional reserve currencies, strengthen economic ties, and facilitate trade and investment.

Bangladesh-India Trade

On July 11, 2023, India and Bangladesh launched a cross-border trade settlement in Indian rupees to reduce reliance on the US dollar. This system uses nostro accounts for payments, allowing Bangladeshi exporters to receive rupees and settle import bills accordingly. Between July and December 2023, two banks facilitated transactions worth 3.51 million rupees. Despite this, Bangladesh faces a trade deficit with India and challenges in using the rupee due to high demand for US dollars and limited rupee earnings.

D. Trade opportunity in local currency in SAARC

Trade in local currency in SAARC has huge potential as well as vast challenges and risks because of the disparity in economy size and trade among the member countries. In Asia, regional trade and investment have experienced rapid growth over the past two 18 decades, accompanied by a strong desire to deepen regional integration through institutional arrangements. The emergence of an effective regional trade community and intra-regional trade enhancement crucially depends on its attractiveness as a medium of exchange, store of value, and unit of account. This would require the establishment of liquid markets with low transaction costs and full convertibility on both current and capital accounts. Against this backdrop, local currency trade is a highly valued concept because of the benefits.

Lesson Learned

Reducing reliance on the US dollar for SAARC trade demands a thorough evaluation of trade volumes, currency acceptability, and infrastructure readiness. This cautious approach is necessary to ensure effective adoption of local currency settlements. Historically, intra-SAARC trade has lagged due to political tensions, trade barriers, and logistical issues. Despite these challenges, regional cooperation and infrastructure improvements are being pursued to boost trade. These efforts aim to overcome obstacles and unlock the full potential of intra-regional trade for economic growth.

E. Potential scopes of local currency trade in Bangladesh

Current trade of Bangladesh by currency

- The level of diversification among several currencies in international trade is essential for a country's participation in multi-currency trade. Countries with extensive experience in participating in currency trades other than the US dollar have a wider opportunity to transition to multicurrency trades. Bangladesh heavily relies on the US dollar for its trade in exports and imports. Bangladesh has engaged in several currency trades, including the US dollar, ACU-dollar, ACU-euro, Japanese yen, and pound sterling, over the years. Nevertheless, the US dollar continued to be the primary driver of exports. The aggregate value of exports reached USD 28.2 billion in FY15, increased to USD 34.2 billion in FY19, and further rose to USD 42.3 billion in FY23, accounting for about 97 percent of total exports throughout the years.
- In a similar vein, the US dollar accounted for the majority of Bangladesh's import payments, with its percentage rising from 80.0 percent in FY15 to 84.4 percent in FY23. A portion of import payments are made using the ACU-dollar, which initially uses the US dollar but settles at the ACU payment settlement period. This ACU-dollar payment gives the country the chance to hold onto some dollars in its reserves for a particular period of time. In FY23, ACU-dollar payments totaled USD 7589.4, or 11.1 percent of the total import payments.
- If the currency wise trade is being considered with India, more than 50 percent export earnings were settled by ACU-dollar in recent years, while the share of export earning in US dollar was 46.4 percent in FY23.
- If currency-wise trade with India is taken into account, in recent years, more than 50% of export earnings were settled in ACU-dollar, whereas 46.4 percent of export earnings were settled in US dollars in FY23.
- Consequently, US dollars are used in the majority of Bangladesh's international trade. To facilitate Bangladesh's import-export trade with other nations, a trade settlement system between the Bangladeshi taka and the local currency of the exporting nation can be implemented in order to lessen the ongoing pressure on the US dollar. Under Memorandums of Understanding (MoU) with traderelated countries, Bangladesh's import trade in local currency can be conducted in a variety of ways involving both central banks and commercial banks.

Possible options of currency trade

Roles of central banks and commercial banks

The People's Republic of Bangladesh's government has the authority to start Memorandums of Understanding (MoU) with the governments of countries with which Bangladesh has substantial import trade, allowing for the payment of import prices in the local currency of each country. The aforementioned Memorandum of Understanding permits the execution of currency swap arrangements central banks or between designated commercial banks.

Currency swap agreement between central banks

Under a MoU, Bangladesh Bank as the central bank of the country can enter into currency swap agreement with the central bank of the country where Bangladesh has significant import trade. Under the agreement for a specified period, a fixed amount of money in local currency will be deposited in the central bank of the respective country as Nostro account in the name of the central bank of the opposite country. In this case, the central bank of the other country will pay the export bill in local currency to the exporters through the exporters' bank of the other country according to the loan demand of the importer's bank of Bangladesh and the approval of Bangladesh Bank from the funds of Bangladesh Bank's Nostro account. The importer in Bangladesh will repay the loan on the due date. In this case, the importing bank will inform the Bangladesh Bank about the repayment of the loan and through the exporting bank of the other country, the amount payable in foreign currency will be deposited as Nostro account of Bangladesh Bank preserved in the central bank of the other country.

Currency swap agreement between designated commercial banks

Under the bilateral currency swap agreement, the local bank operating in Bangladesh designated by the Government of the People's Republic of Bangladesh will open a Nostro account in the bank designated by the government of the contracted country with the local currency of that country. The funds received in the local currency of the other country will be deposited in the Nostro account. Similarly, the bank designated by the government of the other contracting country shall open a nostro account in Bangladeshi currency in the bank designated by the government of Bangladesh. The Bangladeshi currency received through currency swap shall be deposited as the Nostro account. Bilateral currency swap line will be effective in this process. The price of the imported goods will be paid by the importer's bank from the Nostro account of the designated bank of the government of the respective country. According to this process, the importers will pay the import price in the local currency of the country from which they are importing and the exporters will receive their export money in their own country's currency.

Trade deficit settlement

If during the term of any of the above agreements, the trade deficit of either country is greater, after adjusting the import liabilities with the export earnings, the amount equal to the remaining import deficit can be settled in any other foreign currency acceptable to the two countries.

Import payments by means other than opening LC

The Import Policy Order, 2021-24 has provided several facilities for payment of imported goods other than LC which would lessen the pressure on dollar to some extent. Currently, the importers can avail the following facilities:

- Import of daily essential food items through all customs stations of Bangladesh can be done through purchase or sale agreement without any letter of credit without any price limit. In addition, in the case of perishable food products, only 50 thousand US dollars per consignment can be imported through Teknaf Customs Station and 10 thousand US dollars per shipment through other land routes.
- Industrial sector importers can import raw materials, capital equipment and fire doors used in their factories irrespective of the price limit and commercial importers can import any importable product worth more than 500 thousand US dollars annually by paying the price from Bangladesh.

- In order to expand exports, the government can grant permission to import goods regardless of the price limit through TT (Telegraphic Transfer) without opening letter of credit on a case-to-case basis.
- Under the latest banking arrangements signed under the Border Trade Agreement executed in 1994 between the Government of the People's Republic of Bangladesh and the Union of Myanmar, from Myanmar – - Import of rice, dal, maize, beans, ginger, garlic, soybean oil, palm oil, onion and fish in a single consignment exceeding 50 thousand US dollars and in case of other products 30 thousand US dollars in a single consignment; - In case of import of rice under government management, up to USD 2 million in a single shipment can be imported without credit and in this case the maximum limit of USD 5 lakh per year is not applicable.
- As per various instructions of Bangladesh Bank, in case of import of machinery, raw materials for use in own industry, coastal vessels/seagoing ships, agricultural machinery/chemical fertilizers, life-saving medicines, active pharmaceutical ingredients and laboratory reagents, unprocessed yarn, hot rolled coil, scrap, pig iron and sponge for steel industries etc., payment of price may be delayed at various times or goods may be imported against supplier's credit.
- Any importable goods can be sent to the name of a Bangladeshi resident in Bangladesh irrespective of the price limit by direct payment abroad only by expatriate Bangladeshis and the name and address of the consignee must be mentioned in the import document.

The above methods without opening LCs will provide several benefits to Bangladesh's foreign trade sector. It will reduce the pressure on foreign exchange reserves to carry out trade, which will reduce the exchange costs of traders.

F. Recommendations and conclusions

Moreover, Bangladesh needs to focus on expanding its export market before embracing local currency settlements. 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 cooperation in SAARC.

To establish local currency trade with neighboring SAARC countries, the policy makers can focus on the following issues:

- To change exporter/importer attitudes through educational initiatives and capacity building to encourage local currency usage necessitates.
- To gradually relax the capital flows to establish a secure trade settlement system.
- To initiate arrangements or agreements to reduce tariff and non-tariff barriers among member countries.
- To encourage bilateral and regional trade and investment agreements and closer economic relationships to foster economic integration.
- To adopt foreign exchange regulation policies so that the regulations can promote the use of local and regional currencies in trade and investment.
- To introduce new trade settlement/payment systems to facilitate increased use of local currencies.

- To promote cooperation with trading partners, strategic intra-regional production, and trade networks in major export industries to bolster regional economic cooperation.

To enhance local currency trade in SAARC, essential actions include regional initiatives, bilateral agreements, and private sector engagement. These measures aim to improve trading efficiency, reduce costs, and boost trade competitiveness and volumes by minimizing currency conversion complexities.

As Bangladesh prepares to be promoted to a developing country in 2026, trading in local currency will strengthen economic ties and build stronger trade ties between trading 26 partners of SAARC countries and Bangladesh. However, if imbalanced terms of trade exist, a third currency (such as the US dollar) may have to be used to settle the final deficit. In this case, bilateral long-term credit facilities on easy terms can play an effective role. Apart from the agreement between governments or the agreement between private institutions, the matter of executing currency swap agreement between government and private institutions can also be considered.

2.2 Bhutan

Bhutan has maintained this peg to stabilize its currency, the Ngultrum (Nu), has been pegged at par with the Indian Rupee (INR) since 1974, a strategic decision reflecting Bhutan's strong economic ties with India. This fixed exchange rate has brought multiple benefits: reducing trade uncertainties, stabilizing prices, encouraging investments and tourism, and facilitating cross-border transactions. The peg has made Bhutan attractive to Indian tourists by eliminating exchange rate risks and lowering transaction costs. Additionally, the convertibility of INR to Nu has improved the ease of doing business across borders. Bhutan has benefited from India's low inflation, maintaining stable inflationary expectations and contributing to macroeconomic stability, which provides a reliable environment for businesses and consumers. The Royal Monetary Authority (RMA) has been able to maintain financial stability without frequent adjustments to international exchange rate fluctuations.

However, evaluating whether Bhutan's economic characteristics support the optimal currency criteria under the current pegged regime is crucial. Despite its advantages, the pegged exchange rate comes with challenges, particularly the inability to respond to external shocks or changing economic conditions. Any assessment of the peg's effectiveness will depend on Bhutan's evolving economic conditions and objectives.

A. Optimum Currency Area:

An Optimal Currency Area (OCA) refers to a specific geographic region where adopting a single currency would yield the highest economic advantages. Historically, individual countries have typically retained their distinct national currencies. However, Robert Mundell's research in the 1960s proposed that this conventional approach might not be the most efficient economic structure. Specifically, the nations with strong economic ties might do better if they used the same currency. This helps their financial markets work together better and makes trading easier. But it also means that each country gives up some control over their money policies to keep their economy stable.

In this regard, we examine the specific economic characteristics outlined by Robert Mundell in 1961 for an OCA. This analysis aims to determine whether Bhutan's current macroeconomic indicators align with these criteria and support the sustainability of its fixed exchange rate arrangement with India. The OCA theory provides a framework for countries to assess the advantages and disadvantages of adopting either a fixed or flexible exchange rate system based on their economic situations. However, it's important to note that no universally agreed-upon method or index definitively indicates whether a country should join a currency union or not. Therefore, we assess four commonly used criteria to gauge Bhutan's suitability for such an arrangement.

Labour mobility: Labor mobility is really important when countries decide to use a fixed exchange rate. If workers can easily move between countries, it helps to ease the problem of unemployment and wage differences. In Bhutan, the majority of the foreign workers are from India, and at the same time, Bhutanese workers can legally work in India. For example, from 2014 to 2018, around 2,201 Bhutanese workers worked in India on average. Kinds of literature have also recognized the significance of labour mobility in many countries.

Trade Integration: The more deeply integrated an economy's trade is with its partner nation, it's more beneficial to use a fixed exchange rate. If a country sets a fixed exchange rate peg, it gets rid of this problem and facilitates seamless international trade. Although Bhutan's trade diversification with other countries has been expanding, India predominantly remains as its largest trading partner.

Symmetrical Shock: While there are potential trade benefits associated with a pegged exchange rate, challenges may arise if a country's economic cycle does not align with that of its primary trading partner, against whose currency the exchange rate has been fixed. Consequently, the level of cyclical synchronization becomes a crucial factor in assessing the effectiveness of such a regime. Ideally, countries should share similar preferences concerning key macroeconomic variables such as GDP or they should be able to swiftly reach consensus on target values, particularly during periods of crises and unforeseen shocks.

Fiscal Integration: A strong fiscal integration among countries allows them to cushion economic shocks by sharing funds. This helps them maintain fixed exchange rates with lower costs. However, Bhutan's situation is unique. Its fiscal policies are closely tied to India's, especially for development projects. India heavily funds Bhutan's hydropower projects, creating jobs and creating investment avenues. Additionally, India's 2014 and 2024 Economic Stimulus Plan aimed to boost small- scale industries and employment, highlights the significant fiscal ties between the two countries. India also plays a major role in financing Bhutan's development plans, showcasing the depth of their fiscal partnership.

B. Exchange rate Development

In the view of considering the one-to-one peg of Nu to the Indian Rupees (INR), the fluctuations in the INR also directly impact the standing of the Ngultrum in international markets. So, if the INR depreciates internationally, the Ngultrum does too. In the last two years, the INR has experienced considerable volatility and has undergone a significant depreciation against the Greenback. This happened because the aggressive tightening of monetary policy by the US Federal Reserve1 made it harder to get money, and US Treasury yields2 went up. Additionally, the combination of elevated crude oil prices and Foreign Portfolio Investment (FPI) outflows from Indian capital markets has placed additionalpressure on the INR3. The INR has been in depreciation, especially after the supply chain disruptions given the geopolitical fragmentation and rising cost of crude oil. More than 85 percent of India's energy requirement depends on crude oil imports and higher oil import bills have put strain on India's trade balance.

C. Major Trading Partner

India has been Bhutan's largest trading partner with an import value of Nu 85 billion in 2023 alone. This relationship is strengthened by their geographical proximity and historical ties. China followed closely as the second-largest trading partner with an import value of Nu. 6.8 billion, indicating a consistent growth in trade relations over the past few years. Singapore also played a significant role, with trade amounting to Nu. 5.5 billion, providing Bhutan with access to global markets. Bhutan's trade relations extended to other member states, promoting regional economic cooperation. These main trading partners are crucial to Bhutan's economic development and efforts towards trade diversification, highlighting its commitment to promoting regional economic cooperation and integration.

D. Alternative Exchange Rate Regime

The choice and structure of an exchange rate regime are critical considerations for policymakers, as they impact a country's ability to manage its economy effectively, maintain financial stability and respond to various economic challenges. Developing countries with limited capital mobility typically experience relatively low-price levels and often opt for pegged exchange rate regimes. Exiting from pegged exchange rate regimes has historically been associated with crisis and decline in economic activity.

India will likely continue to be Bhutan's primary trading partner for the foreseeable future. The close geographical proximity, historical ties and economic interdependence between India and Bhutan have contributed to this enduring trade relationship. Thus, any attempt to transition away from a pegged exchange rate regime requires a meticulous assessment of the economic fundamentals. Any attempt to deviate from the current exchange rate regime will have serious implications for Bhutan, as the exits from fixed to other regimes are very complex from an institutional and operational perspective. The challenges in various economic factors such as foreign exchange reserves, fiscal sustainability, capital mobility, and export diversification can present a significant challenge for Bhutan's macroeconomic management and stability if the current exchange regime is abandoned.

The choice of exchange rate regime is not solely determined by economic fundamentals but also represents a broader monetary policy framework. This monetary policy framework or strategies include Exchange Rate Anchor, Monetary Aggregate Target, Inflation-targeting Framework and Others that have no explicitly stated nominal anchor (including Bhutan).

E. Recommendation:

The advancement of digital assets and FinTech underscores the need for a prudent monetary policy. While Bhutan does have challenges concerning its fixed exchange rate regime, which limits the flexibility of monetary policy operations, the Department of Macroeconomic Research & Statistics is actively exploring alternative policy approaches that align well with the unique fundamentals of the Bhutanese economy. In pursuit of this goal, the Department is engaged in ongoing discussions with international institutions and central banks. The collaboration aims to establish a framework that best suits Bhutan's economic context. Since the majority of our trade is with India, and considering all the macroeconomic benefits, it can be acknowledged that it is in the best interest of Bhutan to trade in the Indian Rupee.

2.3 India

A. An Overview of Local Currencies Trade settlement of India

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

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

In December 2021, the Reserve Bank of India (RBI) constituted an Inter-Departmental Group (IDG) on the Internationalization of the Indian Rupee, which recommended using local currencies in trade settlements. The IDG suggested that the Local Currency Settlement (LCS) framework would ease business and reduce reliance on hard currencies. Recommendations include liquidity arrangements through bilateral swaps and improved investment access in domestic markets. The RBI's MoUs with the Central Bank of UAE (2023) and Bank Indonesia (2024) are steps in this direction, with further discussions ongoing with other countries.

B. Settlement of in Local Currency Settlement System: Need and Relevance

Local currency settlement allows exporters and importers to limit exchange rate risk, reducing India's current account deficit and the need for large foreign exchange reserves in convertible currencies. Expanding the use of local currencies with major trading partners is thus highly beneficial for India.

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	TotalTrade
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	SriLanka	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 (USDmillion)	Import (USDmillion)	Trade deficit(USDbillion)	Forex data(USD billion)	Comfort of forexreservetocover 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
SriLanka	17,044.51	17,945.63	0.90	4.5	Yes

Sources:InternationalMonetaryFund(IMF)andCentralBankWebsites;

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

C. 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.

Transactions between countries are currently done through banks using the SWIFT messaging system and national payment systems, but future integration of national digital payment platforms could make transactions more efficient. A local currency settlement (LCS) system offers currency diversification, stabilizing local currencies and providing a natural hedge against currency risks. It also reduces transaction costs and facilitates faster transfers. The LCS framework includes establishing correspondent banking relationships in local currencies, using national payment systems, and requiring bilateral domestic currency swaps. The Inter-Departmental Working Group of the RBI suggested adopting a common template for these arrangements, and exploring local currency swaps to manage liquidity. Encouraging international usage of the INR requires sufficient liquidity at the government and central bank levels once a certain threshold of INR settlements is reached. Hedging complexities may arise, but allowing users to hedge according to their country's regulatory regime can simplify the process. The LCS system aims to boost trade and economic cooperation while reducing dependency on third-party currencies, though its success depends on effectively managing challenges and ensuring balanced benefits.

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.
- 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 banks of the partner trading country 5.
- 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, includingremittances. 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 Internationalization 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 rationalized 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.
- India's regime for FPI investment in debt has evolved with the introduction of the Voluntary Retention Route (VRR) and Fully Access Route (FAR), alongside the Medium-Term Framework (MTF), catering to different non-resident investment philosophies. These reforms have led to the inclusion of Indian government bonds in J.P. Morgan and Bloomberg's emerging markets indices, starting June 2024 and January 2025, respectively. The RBI's key priority agenda for 2024-25 will facilitate trade settlements and the internationalization of the INR.

- Non-residents to be allowed to open INR accounts only with the overseas branches of Authorised Dealers (ADs) for the purpose ofundertaking 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.

D. 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.

E. Prospects and Way Forward

The prospects for a Local Currency Settlement (LCS) system are promising, as countries seek to reduce dependence on major global currencies and enhance economic sovereignty. LCS systems can lower transaction costs, mitigate exchange rate risks, and boost regional trade by making transactions more efficient, fostering closer economic ties.

The seamless implementation of LCSS requires a coordinated approach among multiple dimensions including regulatory harmonization. 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.

Adopting Local Currency Settlement (LCS) systems can enhance economic resilience and regional integration by building robust financial infrastructure, regulatory alignment, and trust in local currencies. Overcoming challenges and leveraging technology can promote widespread LCS use, contributing to a stable and diversified global financial system.

2.4 Maldives

A. Background

Cross-border settlements in South Asia are heavily reliant on the US dollar, a dependency that has proven problematic, particularly during periods of global crisis when the dollar appreciates. In response, central banks in the region are exploring alternatives to reduce reliance on the US dollar, a move expected to mitigate financial spillovers and foster deeper trade and financial integration. The Maldives Monetary Authority (MMA) has been studying local currency settlement arrangements with India since 2020, recognizing India's significant role in the Maldives' economy, especially in merchandise imports and rising tourism revenues. However, the trade balance between the Maldives and India has consistently been in deficit for the Maldives from 2016 to 2023, and incomplete data on service balances complicates the accurate assessment of overall trade. A key challenge in implementing local currency settlements is the rapid depletion of Indian Rupee (INR) balances in the Maldives' Nostro or Asian Clearing Union (ACU) accounts, necessitating frequent replenishment that often requires US dollars, thus not fully eliminating USD usage. For local currency settlements to be effective, sectors that earn foreign currency must be open to accepting payments in currencies other than the US dollar. To address these challenges, the MMA has prepared policy notes, engaged with stakeholders, and participated in workshops, with plans to further consult with commercial banks and industry representatives to refine the local currency settlement mechanisms.

B. Current studies conducted

Since 2020, the Maldives Monetary Authority (MMA) has been conducting a study on establishing a local currency settlement arrangement with India. Merchandise imports from India constitute a significant portion of the Maldives' total imports. Simultaneously, the influx of tourists from India has been rising in recent years, which has further strengthened the overall trade balance between the two countries.

Analyzing the trade relationship between the Maldives and India can help identify the potential scale and feasibility of a local currency settlement arrangement. The following table provides estimates of merchandise and service between the two countries.

Table 1: Bilateral Merchandise Deficit between the Maldives and India

In million of US dollar

	2016	2017	2018	2019	2020	2021	2022	2023
Marchandise Deficit	**(273.96)**	**(284.69)**	**(283.74)**	**(286.94)**	**238.54**	**312.06**	**489.98**	**539.83**
Marchandise Export	1.56	2.86	2.82	3.41	3.34	5.96	6.44	5.15
Marchandise Import	275.51	287.55	286.55	290.35	241.88	318.02	496.42	544.98

India held the largest share of imports to the Maldives from the Asian region, accounting for 16% of total imports. Within the SAARC countries, India's share exceeded 70%.The merchandise trade balance between the two nations recorded a consistent deficit from 2016 to 2023, with the volume of trade increasing over time, primarily due to rising import demand from the Maldives. In 2023, imports from India were predominantly driven by construction-related and food items, while exports to India experienced a slight decline, mainly due to reduced earnings from all categories of fish exports during the year. The merchandise trade deficit has widened as imports from India have grown, while exports have remained relatively stable.

Table 2: Bilateral Service Balance between the Maldives and India

In million of US dollar

	2016	2017	2018	2019
Service Balance	**93.79**	**153.72**	**170.16**	**278.39**
Service Export	**93.79**	**153.72**	**170.16**	**278.39**
Service Import	-	-	-	-

In terms of service receipts, the largest component is tourism receipts from Indian travelers. In 2019, Indian holidaymakers became the second-largest market for the Maldivian tourism industry, accounting for 10% of the total tourist arrivals. A total of 166,030 tourists from India visited the Maldives that year, recording a massive annual growth of 84%. This growth can largely be attributed to increased flight connections between the two countries and intensified promotional activities

C. Main issues and challenges

The Maldives is anticipated to be a net importer, which will influence the balance of local currency settlements. This net importer status means that the Maldives will likely face challenges in maintaining adequate local currency balances. Additionally, The MMA is still determining whether settlements will occur among central banks, solely through commercial banks, or via the ACU mechanism. While there are benefits to local currency settlement arrangements, there are various challenges that could arise depending on the type of local currency arrangement adopted.The challenges outlined as follows:

- **Rapid Depletion of INR Balances:** Due to the net importer status, INR balances in Nostro or ACU accounts are likely to deplete quickly, requiring frequent replenishment.
- **Continued Use of USD:** Replenishing INR or settling net amounts will still require USD, even if local currency settlements are managed by commercial banks without central bank involvement.
- **Acceptance of Non-USD Currencies:** For the local currency settlement mechanism to be successful, foreign currency-earning sectors in the Maldives must be open to receiving currencies other than the US dollar.
- **Trade Gap Management:** Addressing the trade imbalance might necessitate a local currency swap to effectively settle the trade gap.

D. Actions Undertaken at Present and Way Forward

The following table provides a summary of the work undertaken regarding the local currency settlement arrangement:

Year	Actions undertaken
2020	Prepared a policy note on the local currency settlement arrangement between the Maldives and India.
February 2021	The policy note was shared with the High Commissioner of India (HCI) to the Maldives.
2021	Meetings were held with the High Commissioner of India and the Reserve Bank of India (RBI).
2021-2022	Technical staff of MMA participated in workshops conducted by ACU and RBI. After the workshops, queries regarding the mechanism were discussed and submitted.

The MMA intends to engage with key stakeholders, particularly commercial banks and industry representatives, to assess their views on local currency settlement arrangements. Additionally, the MMA is still evaluating the settlement mechanism, with options under consideration including central bank settlements, direct settlements through commercial banks, or using the ACU mechanism.

2.5 Nepal

A. Overview

Nepal, a land-locked South Asian country, shares its northern border with China's Tibet region and its eastern, southern, and western borders with India. Historically, Nepal's trade was concentrated with India and Tibet, expanding globally after 1951. Due to the open border and close socio-cultural ties with India, both Nepalese and Indian currencies were used in border areas. Before the Nepal Rastra Bank (NRB) was established in 1956, exchange rate volatility between the Nepalese and Indian currencies caused public concern. NRB stabilized the exchange rate in 1960, fixing it at NC 160 per IC 100. Nepal now has an open trade regime, with trade-related rules governed by the Ministry of Industry, Commerce, and Supplies, and the Department of Customs under the Ministry of Finance.

Further the regulation on currency exchange required in international trade is done by Nepal Rastra Bank, Central bank of Nepal. The trade concentration of Nepal accounts more than 60% with India only while the share is less with rest of the countries in the region.

Since most of the trade concentration of Nepal is with India, trade settlement in INR with other convertible currencies is justifiable. Currency used in transaction settlement is ACU Dollar, ACU Euro and ACU Yen. Moreover, Nepal's Trade transaction with Bhutan can be settled with INR in addition to ACU mechanism as per the provision of NRB. Presently Nepal has fixed exchange rate system with India and convertible exchange rate with other 20 currencies across globe. In SAARC region, Nepal has direct exchange rate convertibility with Indian Currency Only. Other convertible currencies are: USD, EUR, GBP, CHF, AUD, CAD, SGD, JPY, CNY, SAR, QAR, THB, AED, MYR, KRW, SEK, DKK, HKD, KWD and BHD. Besides, import of goods and services from India can be done through LC, draft or TT but for import above INR 3 crore must be done through LC. Imports from India are normally paid in Indian Rupees. The Nepal government permits imports from India to be paid in hard foreign currency for some products, highlighting the importance of direct currency convertibility in trade. In the SAARC region, reliance on internationally convertible currencies limits economic cooperation despite the region's potential for growth. Intraregional trade could be a major driver of economic progress, but the reliance on external currencies is a significant hurdle. Effective implementation of the South Asian Free Trade Area (SAFTA) and SAARC Agreement in Trade in Services (SATIS) depends on achieving currency convertibility among member countries. Challenges remain in adopting local currencies for trade in the SAARC region.

B. Challenges

Currency Convertibility: Nepal has pegged exchange rate system with India. The provision for currency exchange is not formulated for rest of the countries in the SAARC region. For transaction settlement, businesses go through either INR or other convertible Currencies.

Low transaction: Except India, the volume of trade and other transactions is less with other countries in the region. In the fiscal year 2022/23, combined import portion with other SAARC countries except India is around 0.52% of total import, while combined export portion with other SAARC countries except India is around 0.82% of total export.

Legal Framework and Institutional setup: Trading in local currencies require legal framework for currency convertibility which is yet to be developed. Moreover, robust financial system within the country is required to handle large scale local currency trade.

Limited Financial Infrastructure: The financial systems within SAARC countries might not be robust enough to handle large-scale local currency trade. Deficiencies include: Payment Mechanisms: Lack of efficient systems to transfer funds between

SAARC countries in local currencies.

Settlement Systems: Difficulty in finalizing transactions and ensuring timely receipt of payments.

Money Laundering and Terrorism Financing: Local currency convertibility might attract money laundering and terrorism financing across region. Moreover, trade based money laundering and terrorism financing might increase due to direct currency convertibility.

Confidence in local currencies: India demonetized banknotes in November 2016, but the exchange of demonetized currency held in Nepalese banking system is not done. Such incidence lowers the confidence in use of local currencies.

C. Possible Solutions

Gradual Currency Convertibility: SAARC countries can progressively loosen restrictions on currency convertibility. This would allow for increased circulation and easier trade settlements in local currencies.

Currency Swap Arrangements: Central banks within SAARC could establish agreements to exchange currencies at predetermined rates. This would mitigate exchange rate volatility and provide businesses with more predictability.

Developing Regional Payment Systems: Creating a dedicated regional payment system for SAARC trade would streamline transactions. This could involve:

- Establishing a regional clearinghouse for settling payments in local currencies.
- Integrating existing payment systems of member countries.

Promoting Regional Political Cooperation: Improved political relations between SAARC members would foster trust and create a more favorable environment for economic integration. This can be achieved through:

- Regular dialogue and confidence-building measures between governments.
- Addressing political disputes and fostering regional stability.

By working together, SAARC countries can unlock the potential of local currency trade and create a more prosperous and integrated south Asia.

D. Recommendations:

Harmonization of Regulations: SAARC countries could work towards standardizing regulations and streamlining administrative procedures to facilitate local currency trade.

Infrastructure Development: Investing in robust financial infrastructure, including payment systems and clearing mechanisms, is essential for supporting local currency transactions.

Capacity Building: Initiatives to enhance financial literacy and awareness among businesses and consumers can promote the adoption of local currency trade.

Policy Coordination: Coordination among SAARC member states on monetary policies and exchange rate management can promote stability and confidence in local currencies.

Public-Private Partnerships: Collaboration between governments, central banks and the private sector is crucial for driving the adoption of local currency trade through targeted initiatives and incentives.

By addressing these challenges and capitalizing on the prospects, SAARC countries can potentially unlock the benefits of trading in local currencies, contributing to regional economic growth and integration.

2.6 Pakistan

A. Background

The Bretton Woods agreement (1944) created an international currency exchange regime that lasted from the mid-1940s to the early 1970s, requiring a currency peg to the US Dollar, which was in turn pegged to the price of gold. Although the Bretton Woods system collapsed in the 1970s due to the inflexibility of the US Dollar peg in sustaining global trade growth, the US Dollar has remained dominant in global trade for decades, largely due to the US being the world's largest economy and the fact that oil and most commodities are priced in US Dollars.

However, several developments have motivated emerging and developing countries to develop alternative trade settlement systems to move away from Dollar settlement in international trade. Some of these motivations include:

1. The US and developed countries unilaterally denying other countries access to settlements in US Dollars and other reserve currencies through unilateral and multilateral sanctions.

2. Lack of consideration for global economic consequences in their monetary policy decisions by the Central Banks of advance countries.

3. Irresponsible fiscal policies adopted by the US and the developed world, eroding the value of these currencies for external users in trade.

4. The limitation of a country's ability to participate in global trade based on its holdings of US Dollars and other reserve currencies.

5. The gradual decline in the active role of Bretton Woods institutions (IMF and World Bank) in the global economy.

For instance, the US and the EU froze around $300 billion of Russia's foreign reserves and cut its major banks from accessing the SWIFT network to cripple the Russian economy, while also preventing Russia from servicing its debt to international creditors. Similarly, the US froze $7 billion of Afghanistan's foreign exchange reserves post-Taliban takeover. Additionally, as the Federal Reserve embarked on an aggressive interest rate hike strategy, central banks in developing countries were forced to raise their own interest rates to counter sharp depreciations in their currencies.

B. Local Currency Settlement System

The Local Currency Settlement System (LCSS) enables cross-border trade payments in national currencies, contrasting with the multilateral Bretton Woods System that uses reserve currencies like the US dollar. LCSS is mostly bilateral and aims to boost regional trade, financial integration, and resilience by reducing reliance on traditional reserve currencies. Countries like

China, BRICS, ASEAN, India, and Indonesia are developing frameworks to promote local currency trade, with Saudi Arabia also considering pricing oil in Yuan.

Benefits of Local Currency Settlements

A large number of factors are compelling emerging and developing economies to opt for local currency settlement mechanisms during the last few years.

Lower transaction costs: LCSS eliminates the cost of exchanging domestic currency with the international reserve currency like the US Dollar. The involvement of such a third-party currency indeed raises transaction cost of the trade.

Reduced Risk of Capital Flight: Lower use of the US Dollar and thus lower reliance on it will reduce the adverse impact of US monetary policy on domestic exchange rate and hence the reduced risk of quick capital outflows from the EMEs, due to the US Federal Reserve's monetary policy decisions.

Sanctions Prone: Thelocal currency settlement helps to avoid the adverse effects of political or unilateral sanctions.

Internationalization of domestic currency: LCSS helps national currencies to get higher international status. Trade in the concerned domestic currencies will go up with LCSS.

Removing frictions to trade and investments: Trade and investment will be encouraged with easier and less costly payment settlements. The LCSS will also help to develop forex markets in both countries.

Pakistan's experiences with Local Currency Settlement Systems

Pakistan has been engaged in LCSS on both bilateral as well as through multilateral arrangements

C. Pak-China LC Trade Settlement

SBP-PBOC Currency Swap Agreement

In December 2011, the State Bank of Pakistan and the People's Bank of China established a bilateral currency swap agreement (CSA) to enhance trade, investment, and liquidity support. Initially set at CNY 10,000 million, the CSA was renewed and expanded to CNY 30,000 million by 2021, with a maturity period of three months to one year.

Framework for Promoting the use of CNY for Bilateral Trade

The State Bank of Pakistan (SBP) has established a regulatory framework allowing the use of CNY for trade and investment, treating it on par with other major currencies. This has led to an increase in Pakistan's CNY-denominated imports from China, rising from 2% in FY18 to 18% in FY22, with overall local currency trade with China reaching about 15% in FY24.

Off Shore Settlement of CNY in Pakistan

To promote the CNY trade between Pakistan and China, SBP permitted Industrial and Commercial Bank of China Limited (ICBC) Pakistan to establish their local CNY clearing and settlement setup in Pakistan.

The designated banks can

1. Open CNY accounts of the banks operating in Pakistan to facilitate settlement of CNY based transactions such as remittance to/from China.
2. Also provide CNY liquidity to the interbank market for the settlement of CNY based transactions.

The arrangements were expanded by allowing Bank of China Limited (BOC) Pakistan in 2018 and Standard Chartered Bank (SCB) in 2019[1] to establish similar local CNY clearing and settlement mechanism in Pakistan.

Pak-Afghan LC Trade Settlement

Pakistan and Afghanistan have had decades long economic relations. Being land locked, the Afghan Transit Trade Corridor fostered greater economic partnership between the countries. Nevertheless, the official trade volumes in local currencies (Afghani and Pakistan Rupee) remain muted as much of the trade, especially in the border regions of the countries take place informally. This situation was further exacerbated since August 15, 2021, due to change of political regime in Afghanistan, the banking channels have become inactive for carrying out trade transactions with Afghanistan. Amid this development, the trade can be settled in the following manner:

Settlement Mechanism (available under FE regulations) for Trade with Afghanistan:

1. Pakistan’s exports to Afghanistan can be settled through following modes:

   i) Settlement through normal banking channel like any other country (currently due to inactive banking sector, this mode is non-operational presently)

   ii) Settlement through third party arrangement (e.g. proceeds of exports received from UAE; however, to mitigate trade based money laundering risks such arrangement requires tri-partite agreement)

iii) Settlement in foreign currencies notes (FCY, mostly USD) brought over the counters of the banks by the exporters subject to providing currency declaration issued by Pakistan Customs.

2. Pakistan's imports from Afghanistan can be settled through following modes:

   i) Settlement through normal banking channel like any other country (currently due to inactive banking sector, this mode is non-operational)
   ii) Settlement through third party arrangement (requiring tri-partite agreement; however correspondent banks are avoiding such transactions amid US sanctions on Taliban).
   iii) Settlement without the requirement of Electronic Import Form (EIF)/FI, imports in PKR are allowed by Pakistan Customs/FBR, without involvement of banks.

Asian Clearing Union

Founded in 1975, ACU is the oldest institution for regional co-operation in Asia, allowing participating Central Banks to settle their dues in three currencies including ACU Dollar, ACU Euro and ACU Yen. Although the union has offered much promise, there have been certain setbacks eroding its effectiveness. Firstly, although intra-regional trade in Asia has been consistently growing, the operations through the Asian Clearing Union are limited. Secondly, the membership and hence the coverage of the association has stalled. And thirdly although Initially aimed at promoting use of regional currencies in trade settlement, ACU switched to convertible currencies in 1996 due to traders facing difficulties with domestic currencies such as high volatility, time lag in availability of exchange rates and lack of hedging instruments and financing facilities.

D. Pakistan's experience: Challenges with LCSS

Over time, the following experiences of Pakistan are worth highlighting:

1. The volume of trade is an important factor for the success of Local Currency Settlement Systems. For example, the trade within the SAARC Region is significantly much lesser than the other regions which undermines the effectiveness of using local currencies. Nevertheless, this also indicates the potential of increasing the local currency settlement in SAARC.
2. Despite the framework being in place, the success of the system depends upon the utility of the users. In many cases where the value chains of trade are not fully internalized, the exporters continue to prefer the US Dollar based payments due to ease of making payments to their foreign suppliers to avoid the cost of conversion of local currency to Dollars.
3. Volatility in the exchange rate have also seen to have an effect on the acceptability of local currencies for cross border trades. (Pakistan's CSA with Turkey expired unutilized due to this factor).

4. Banks are generally reluctant to open accounts of foreign companies/individuals based in/linked with sanctioned or high-risk countries, as authentic information regarding KYC requirements is not generally available for proper Customer Due Diligence (CDD).
5. The usability of the local currency and liberalized access for the non-resident users of local currencies in respective countries is also critical for increasing the acceptance of bi-lateral settlement arrangements.

2.7 Sri Lanka

A. Background

Trading in local currencies is an evolving approach where transactions are conducted using domestic currencies rather than widely accepted international ones like the US dollar. For instance, trade between Sri Lanka and India using the Sri Lankan rupee and the Indian rupee exemplifies this method. With the increasing establishment of bilateral and regional agreements aimed at reducing reliance on major international currencies, the practice of trading in local currencies is expected to expand further.

However, trading in local currencies faces significant challenges, including liquidity issues, currency stability, and the need for efficient payment systems. Some local currencies are not widely traded, posing challenges for completing transactions, while political or economic instability can affect currency stability. Additionally, developing or integrating payment platforms to support local currency transactions is essential. Administrative complexities in managing multi-currency accounts and financial reporting also add to the challenges, increasing the administrative burden on businesses and financial institutions.

The benefits of trading in local currencies are substantial, particularly for developing economies. By reducing dependency on major currencies, countries can lower the costs associated with currency conversion and foreign exchange risks. It also emphasizes the importance of comprehensive data collection and collaborative research within the SAARCFINANCE database to better understand and leverage the advantages of local currency trading. Such efforts can help SAARC countries navigate global economic challenges and improve the efficacy of local currency trade across various sectors.

B. Benefits of Trading in Local currency

- Reduced Dependency on Major Currencies: This can help mitigate risks associated with exchange rate volatility and political influences from major economies.
- Strengthening Regional Trade Blocs: Trading in local currencies can reinforce regional trade agreements and economic blocs, thereby promoting closer economic integration.
- Promoting Economic Sovereignty: Countries can enhance their economic sovereignty by fostering the use of their own currencies in trade, leading to more stable economic policies and a reduced vulnerability to external economic shocks.
- Facilitating Trade Among Developing Economies: Trading in local currencies can lower the costs associated with currency conversion and reduce foreign exchange risks, encouraging trade and economic cooperation among developing nations.

C. Challenges and Risks of Trading in Local Currency

- **Liquidity Issues**: Certain local currencies may not be widely traded or easily convertible, potentially complicating transactions and creating challenges in the timely settlement of payments.

- **Currency Stability Concerns:** The stability of local currencies is often influenced by a country's political or economic circumstances, which may pose difficulties in their use for trade.
- **Inadequate Financial Systems:** Insufficient financial infrastructure and payment mechanisms can result in transaction delays or settlement failures, further complicating the trading process.
- **Administrative Complexities:** The management of multi-currency accounts, billing, and financial reporting can impose significant administrative burdens on businesses engaging in local currency transactions.

D. Key Considerations for Adopting Local Currency Trading in the SAARC Region

- SAARC countries may need to establish or expand existing agreements to support local currency trading.
- The creation of efficient and reliable regional payment systems is crucial for implementing local currency trading effectively.
- Building capacity among businesses and financial institutions to handle local currency transactions is crucial for the success of this initiative.
- Coordinated policies and regulatory frameworks across South Asian countries are essential to promote and sustain local currency trading.

Export Performance in the SAARC Countries

Bilateral Trade Agreements between India (ISFTA), Pakistan (PSFTA) with Sri Lanka and Regional Trade Agreements such as South Asian Free Trade Area (SAFTA) significantly contributed to increase Sri Lanka's exports to SARRC region.

The variety of exported goods enhances Sri Lanka's diverse economic capabilities and strategic trade practices within the SAARC region.

Table 01: Export Performance of Sri Lanka in the SAARC Countries

USD mn

Country	2019	2020	2021	2022	2023
SAARC Region	1,133	917	1,259	1,259	1,217
Total	11,939	10,047	12,221	13,105	11,911
Exports to SAARC Region (as a % of Total)	9.5%	9.1%	10.3%	9.6%	10.2%

From 2019 to 2023, Sri Lanka's exports to the SAARC region have remained relatively steady. The highest export value during this period was US$1,259 million in 2022, followed by a slight decrease to US$1,217 million in 2023. Despite this small drop, the SAARC region's share of Sri Lanka's total exports reached 10.2% in 2023, underscoring its growing importance in Sri Lanka's export strategy. This data highlights the need for Sri Lanka to continue strengthening and expanding trade relations with SAARC countries. The diverse range of goods exported reflects Sri Lanka's broad economic capabilities and strategic trade practices within the region.

Import Performance in the SAARC Countries

Both bilateral and regional trade agreements have helped imports from the region although imports under these agreements were not significant. As Sri Lanka continues to navigate its economic path, maintaining and strengthening this trade relationship will be crucial.

Table 02: Import Performance of Sri Lanka in the SAARC Countries

USD mn

Country	**2019**	**2020**	**2021**	**2022**	**2023**
SAARC Region	4,343	3,486	5,323	5,319	3,660
Total	19,935	16,053	20,635	18,289	16,811
Imports to SAARC Region (as a % of Total)	21.8%	21.7%	25.8%	29.1%	21.8%

Sri Lanka's import landscape within the SAARC region over the period from 2019 to 2023 was notable, consistently accounting for more than 20 per cent of total imports. From 2019 to 2023, Sri Lanka's total imports from SAARC countries ranged from US dollars 4,343 million to US dollars 3,660 million. This indicates a dependency of Sri Lanka on SAARC countries for imports over the years. Sri Lanka's imports from SAARC member countries are crucial and significant.

Sri Lanka's Trade Performance in the SAARC Region

Table 3: Sri Lanka's Trade Performance in the SAARC Region (USD mn)

Country	**2019**	**2020**	**2021**	**2022**	**2023**
Trade Balanc to SAARC Region	**-3210**	**-2570**	**-4065**	**-4060**	**-2444**
Export to SAARC Region	1,133	917	1,259	1,259	1,217
Imports to SAARC Region	4,343	3,486	5,323	5,319	3,660

The trade deficit reached US dollars 4,060 million in 2022. The trade deficit showed a decreasing trend until 2020 and recorded US dollars 2,570 million, reflecting some improvement in the trade balance during this period. The trend of trade balance indicates that Sri Lanka is consistently spending more on imports than earning from exports within the SAARC region.

D. Further Studies are Needed on the Key Related Areas in Trading in Local Currencies

In the context of the Balance of Payments (BOP), trade account discussions are primarily focused here, but it is also essential to consider the Services account, Secondary Account, Financial Account, and Capital Account. Each of these accounts plays a crucial role in shaping a country's external economic engagements.

Access to more detailed data in the SAARCFINANCE database is vital for enhancing the evaluation of intra-regional economic cooperation. Upcoming suggested collaborative research is expected to offer significant insights, advancing our understanding of global economic challenges and improving the benefits of local currency trading across various economic sectors for member countries.

3. Conclusion

Trading in local currencies within SAARC countries offers a strategic pathway to reduce dependency on major global currencies, enhance regional trade integration, and strengthen economic development. However, few challenges such as exchange rate volatility, underdeveloped financial markets, and varying levels of economic stability across member states. Despite these obstacles, the prospects for local currency trading remain promising if SAARC countries can pursue coordinated efforts to enhance inter regional financial cooperation, bilateral trade agreements, currency swap facilities to develop robust financial infrastructure, and establish mechanisms to mitigate exchange rate risks. By development of stronger institutional cooperation and promoting policy harmonization, SAARC can unlock the full potential of local currency trading, contributing to greater economic stability and regional prosperity. The success of these initiatives will depend on the political will, commitment to economic reforms, and the active involvement of both public and private sector stakeholders in the region.

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