International Journal of Latest Research in Humanities and Social Science (IJLRHSS)
Volume 07 - Issue 05, 2024
www.ijlrhss.com || PP. 135-141

The Polarisation of Currency Preferences

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Abstract: All sorts of cross-border activities promote demand for and supply of foreign currency, which is catered through the foreign exchange market of the country. Historical data shows that the Advanced countries' currencies were more preferred for any cross-border transactions and even to maintain the foreign exchange reserves in the form of national security. Due to rapid changes in the geopolitical scenarios and international relations in the world, countries, other than advanced countries or EEC members, are about to change their currency preferences and are trying to revamp country's foreign exchange market. Country wise the case is differing.

Whether it is Full capital account convertibility or internationalisation of currency, academic discussions of such topics are inevitable. This paper intends to initiate such discussions, taking the process of internationalisation of Indian rupee also into account.

Keywords: Currency, internationalisation, de-dollarization, financial market, trade, etc.

Historical Perspective

After the Second World War, policy makers from the victorious allied powers, namely the US and the UK, took up the task of thoroughly revamping the world monetary system. The outcome of this was the so called "Bretton Woods System" (1947) and the birth of two new international institutions namely, the International Monetary Fund (IMF) and the World Bank (IBRD). The main aim of the Bretton Woods Agreement was to restore the monetary order after the Second World War. This System came under pressure and ultimately broke down in mid 1960s.

India, being a colony of the British was under the influence of their political frameworks, language and more importantly, their currency. India continued with the pound sterling as currency of intervention even after Independence till 1975. During this period many countries started linking their currencies with a basket comprising of the units of various currencies included in the basket. In such a linkage, the fortunes of the currency of the country do not depend on one currency and thus rates are more stable. On September 25, 1975, rupee was delinked from the pound sterling and was linked to a basket of currencies, by then India's trade had substantially diversified in terms of both currency and countries, therefore, the link with pound alone was no longer logical. The composition of this currency basket as well as their relative weights were kept secret, and pound continued with the tag of 'the intervention currency'.

In July 1991, the intervention currency for India got changed to the US Dollar and 'Dual Exchange Rate' system was taken up by the RBI. In dual exchange rate system, one rate was administered and other one was left to the market forces. Here, 60:40 pattern was adopted, i.e., out of the total receipts of foreign exchange from exports, 60 percent could be sold at the market determined exchange rate and 40 percent had to be surrendered to the RBI at the official rate. It was in late 1992 India shifted completely from the administered or fixed exchange rate system to the floating exchange rate mechanism and adopted the US dollar as the official currency of intervention (wherein the majority of the transactions are invoiced in the US dollar.)

So practically Indian Rupee entered in to the global FX market in late 1992 and started confronted the Dollar dominance of this market, which continues till date. Among the international capital, commodity, financial/ money markets, currency market/ the FX market is the largest market in the World. Largest market in terms of volume and liquidity. The foreign exchange market, which is virtual in nature, refers to a system that facilitates the transaction of currencies from different countries. Each country has got its own sovereign currency and hence any transaction happening in any one of the above three markets in the cross-border form, is backed by the currency exchange. It is performed through credit instruments, such as bills of foreign currency, bank drafts and telephonic transfers. The fund transfer functions through an electronic network of banks, financial institutions, brokers and individual traders. Forex market is an over-the-counter market for the same reason. Forex also finds extensive applications for transferring funds to support the exchange of various goods and services between nations. The FX market is often viewed as an asset capacity on its own. The end-users of the FX market are therefore comprised of a wide variety of financial and non-financial customers around the globe.

In other words, the forex market is a Worldwide network of inter-bank traders comprising primarily of commercial banks and financial institutions, connected by telephone lines and computers. Reuters Group Ltd., an international news agency provides the financial market data, apparently considered as an authentic one. Society for Worldwide Interbank Financial Telecommunication System (SWIFT) brings it into the really. SWIFT is a global member-owned cooperative and the world's leading provider of secure financial messaging services.[1]

Geographically, the forex market covers all time-zones and hence works virtually 24 hours on all working days, enabling a currency trader to offset their positions created in one market using another market. Structure of the forex market is divided into two types – 1. The retail market- is the market where travellers and tourists exchange one currency for another in the form of currency notes or traveller's cheques. The total turnover and the average size of the transaction is very small. Therefore, the spread between buying and selling price is also large. 2. The wholesale market also called as an interbank market. The major categories of the participants in this market are commercial banks, financial institutions, central banks, non-financial institutions, etc. The average transaction size is too large and that is why the spread between the buying and selling price remains quite narrow.

In short, each and every cross border transaction is backed by the currency exchange and therefore, multiple hits on demand for as well as on supply of various currencies, contributes to the volatile nature of the FX market. Volatility in the exchange rates refers to the dispersion of returns and thereby exposing to the currency risk. The exchange rates could display higher volatility because of several factors such as deviation from fundamentals, excessive speculative activities, macroeconomic shocks, or other global and domestic news. Excessive fluctuations in exchange rates could spillover to other segments of financial markets, can blur the monetary policy signals and lead to financial stability problems. Excessive exchange rate fluctuations also have a detrimental impact on foreign trade and at times even on genuine investments. The solution to this is use of an appropriate derivative/hedging tool to hedge the currency exposures. Six months down the line, what is going to be the USD/INR rate is not known today, but merchandise trade or a financial asset sell/purchase is happening today, in such case, locking the future exchange rate through any one of derivative instruments available is a key to this exchange rate risk. This further adds to the number of transactions in the FX market and that's how the size of this market enlarges. Therefore, the largeness of this market gets emphasised again and again. Foreign exchange market has shown itself to be a fertile ground for the derivatives techniques. This is because the currency market is huge in terms of trading volumes and small by way of transaction costs. Secondly, it is fully operational for dealing in spot, forwards, or options nearly 24 hours per day, except for weekends and prominent holidays.

Following graph gives us volume-wise changes in the global FX market, obviously expressed in US dollar.

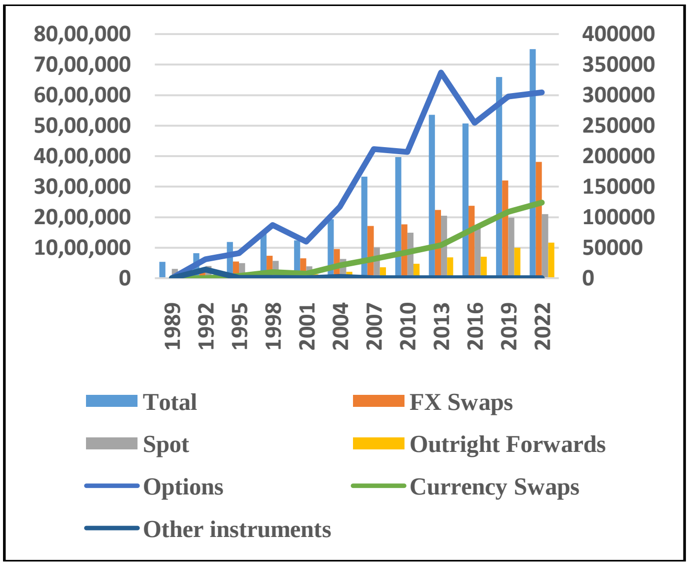

Figure-1 Global Foreign Exchange Market Turnover: Daily averages in mn of US $

Source: BIS Triennial Central Bank Survey of Foreign Exchange and Over-the-counter (OTC) Derivatives Markets.

[1] https://www.swift.com/about-us

Dollar dominance to De-dollarization

There is a very good reason why the dollar is used widely in trade, and that's because we have deep, liquid, open capital markets, rule of law and long and deep financial instruments …. Sanctions are only imposed on countries that are guilty of enormous abuses, including human rights abuses.

—Janet Yellen, US Treasury Secretary

Towards the end of the second World War, the financial markets of advanced countries turned in to the battlefield. The post World War financial system actively started using the United States' Dollar, which was facilitated by the size of the US economy, political influence, US's military capabilities, the largest and exceptionally liquid financial market and instruments, depth and scale of dollar dominated debt securities, no restrictions on capital movements and a crucial role of US multinationals in the global market at that time. Hence, dollar has been the World's most important means of exchange, commonly held as reserve currency and widely used for international trade and financial transactions around the world. So past almost three decades the US dollar has remained the most preferred currencyin the global market and it continues to do so. Dollar dominance in global trade, international debt, international borrowing and lending, etc., is still far outstripping.
If we only take the global foreign exchange market into account, then following two charts clearly exhibits the dollar dominance in the FX market globally.

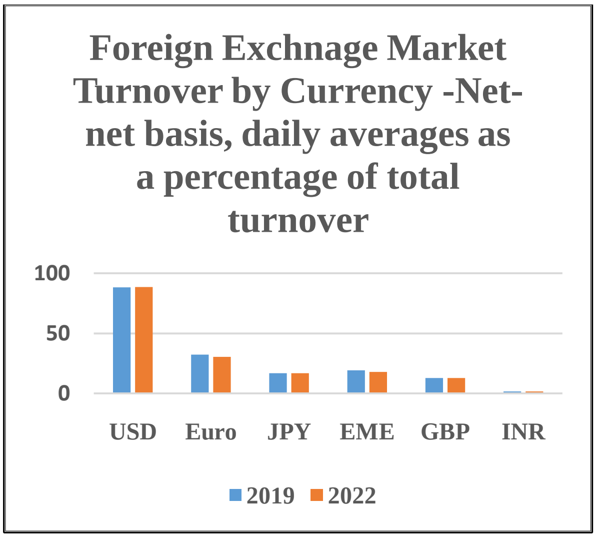

Figure – 2 Source: BIS Triennial Central Bank Survey 2022

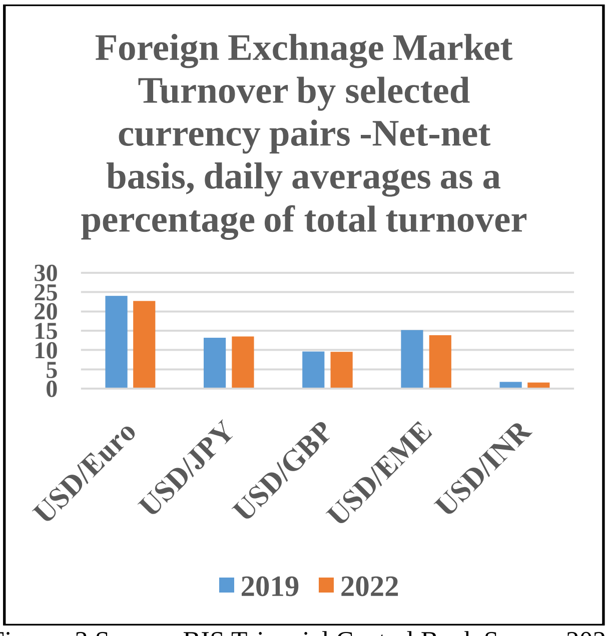

Figure- 3 Source: BIS Triennial Central Bank Survey 2022

*Emerging Market Economy currencies excluding Chinese renminbi and Russian rouble have twenty-six currencies, including INR

The term called, 'De-dollarization' has started appearing in the academic as well as in commercial policies of the countries. De-dollarization can be interpreted in terms of reduction in the use of dollar in world trade and financial transactions and overall reduction in national, institutional and corporate demand for dollar.

December 2023, a news flashed on the Wall Street Journal says, 'The dominat dollar faces a Backlash in the oil market'. An estimated 20 % of global oil in 2023 was bought and sold in other currencies as Russia and Iran sold cargoes to China and other buyers. [2]

Another news against dollar was from Iraq. Iraq to ban cash withdrawals and transactions on Dollar before 2024.

As per the IMF 2022 report, the visible sign of de-dollarization is, the central banks are not holding the greenback in their reserves to the extent that once they did. As per the IMF Currency Composition of Official Foreign Exchange Reserves (COFER) findings, the dollar's share of global foreign exchange reserves fell below 59 percent in the last quarter of financial year 2021-22.

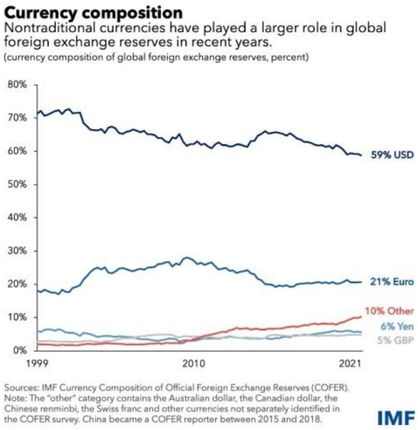

Figure- 4

Above source and graph shows that the share of reserves held in US dollars by central banks dropped by 12 percentage points since the turn of the century, from 71 percent in 1999 to 59 percent in 2021.

Criteria for holding country's reserves in a currency with large, open financial markets, so that they can encash those reserves in difficult times. To weather out economic shocks, pay for imports, pay back service debts, and in case of managed float, intervening in the domestic FX market if required, are some of the difficulties for which Foreign exchange reserves can be relied upon. Due to some significant geopolitical changes and changes in international relations' based preferences of countries, the US dollar as international currency apparently is going to face less demand in the global FX market.

Following are some of the cases of either change in the composition of their foreign exchange reserves or some cases, where local currency promotion is on rise -

Russia – Major chunk of global payments happening in the US dollar and handling of these transactions happens through countries' corresponding banks with their accounts at the Federal Reserve. This itself increases the power of the US government to put financial sanctions on countries whom do they wish to blacklist. Russia has been victimised in the same manner. After the outbreak of Russia-Ukraine war in 2022, the US sanctions cut Russia off from the dollar, leading to freezmore than $600 bnRussian Central Bank's assets. Because of these financial sanctions, Russia defaulted on its foreign debts first time since 1918. As per the Bank for International Settlement (BIS) data sheets and the World Economic Forum reports, European, specifically French and Italian banks have the most exposure to Russia and the Russian debt default case.

On the contrary, Russian finances remained strong throughout this span as India, China and Turkey continued and also increased their oil purchases from Russia.[3]Efforts are still in process to reactivate the Rupee-Rouble Trade Agreements to re-enhanced India-Russia trade.

[2]https://www.wsj.com/finance/currencies/the-dominant-dollar-faces-a-backlash-in-the-oil-market-0f151e28
[3]https://www.iea.org/articles/energy-fact-sheet-why-does-russian-oil-and-gas-matter

The US sanctions on Russia have made some countries decide about their dependency on the dollar. In July 2023, Bolivia, became the third South American country after Brazil and Argentina to pay for its imports and exports using the Chinese Renminbi. Russia has nearly a third of all reserves in China's Renminbi.

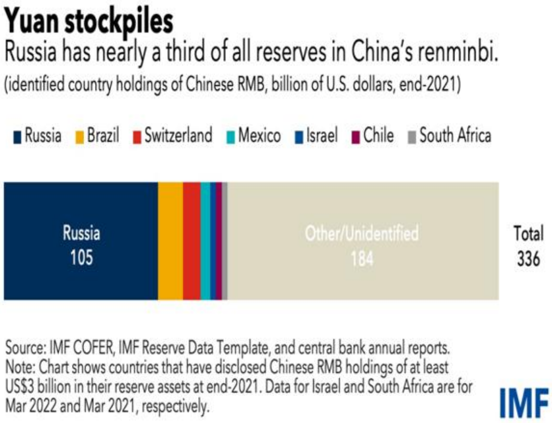

Figure -5

BRICS- At an April 2023 summit of BRICS countries (Brazil, Russia, India, China, and South Africa), Brazilian President Luiz Inácio Lula da Silva asked, "Why can't we do trade based on our own currencies?" For years, BRICS countries leaders have raised the issue of domestic currency devaluation when the dollar rises. Sharing one currency among BRICS countries could be a partial solution and would take care of only trade related transactions. For financial inflows and outflows, capital lending and borrowing purpose, economy would need a strong macroeconomic base, wide, matured, transparent and liquid financial markets and for the same, any economy would need a strong foundation of financial institutions as well. BRICS countries at present are not fully equipped to go for a common, strong currency among themselves. There are many structural challenges going on in each one of the BRICS members.

For the common currency proposal, there is a requirement of specific institutional mechanism and the same has been addressed by setting up the New Development Bank. According to Brazilian economist Paulo Nogueira Batista (2023), this common currency could only be digital and basically meant for the cross-border trade. India's stance on the same would be a key factor because of few geopolitical challenges lying ahead on the same road. China, on the other hand is completely on a different note regarding the common currency, as long back China has initiated its own moment of Renminbi Internationalization.

Regional Settlement Mechanisms:

1. South American SML: Sistema de PagamentosemMoeda Local (Local Currency Payment System) SML is an international payment system to settle bilateral financial transactions in local currencies within the Southern Common Market Countries, i.e., Brazil, Argentina, Uruguay and Paraguay. This bilateral netting is conducted between concerning central banks, working as intermediaries.
2. Eastern and Southern Africa- COMESA REPSS- Regional Payment and Settlement System (REPSS) got developed for Eastern and Southern Africa. The operator and administrator of the REPSS is the Common Market for Eastern and Southern Africa (COMESA) Clearing House. Thus, REPSS is a Multilateral Netting System with End-of-Day Settlement in a single currency (USD or Euro), with the system allowing for settlement in a multicurrency environment (USD, Euro, or any other specified currency). Here also the central bank works as an intermediary.
3. Local Currency Settlement (LCS) – Recently, few central banks have proposed this Local Currency Settlement framework with India to promote and boost and facilitate the settlements of trade and other financial investments. Another financial cooperation scheme proposed is the 'Local Currency Bilateral Swap Arrangement (LCBSA)' between central banks.

China- Chinese Renminbi (RMB) gives the most comprehensive example of several serious efforts at Internationalisation of their currency. China has initiated it since the last few decades. Hu and Chen (2013) developed an index called the RMB Internationalisation Index to assess the process of internationalisation. As per the Inter-Departmental Group (IDG) report 2022, on the internationalisation of Rupee, China is promoting this for various political and economic benefits and also to counter the dollar trap, extend Beijing's global influence. However, less transparent and underdeveloped financial system, continued capital controls and limitations of RMB convertibility could further hinder the internationalisation of RMB.

Internationalisation of Indian Rupee-

'Utkarsh 2022' was launched by the Reserve Bank of India Governor, Shaktikant Das in July 2019 to improve regulation and supervision among other functions of the Central Bank. Utkarsh 2022, three-year medium term strategy, is in line with the global central banks'plan to strengthen the regulatory and supervisory mechanisms.
One of the visionary plan in the RBI Utkarsh 2022 was to foster confidence in the internal and external value of the Rupee and contribute to macroeconomic stability. The Inter Departmental Group (IDG) was constituted by the RBI to review the extant position of Indian Rupee as an international currency and to frame a road map for internationalization of Rupee.

To initiate internationalization of Rupee, the IDG has assessed all relevant, historical international experiences regarding the same and their relevance to Indian Rupee. It obviously starts from colonial period, pound sterling as currency of intervention, dollar dominance in the global FX market, Australian dollar, its major play in the global bond market, Chinese Renminbi (RMB) and its internationalization, etc.

Free Capital movement has always been considered as a hallmark of advanced economies. As recommended by the Tarapore Committee in year 1999 and in year 2006, achieving Full Capital Account Convertibility (FCAC) would certainly require efforts to improve macroeconomic fundamentals and financial market strengthening along with the infrastructure. The IDG also feels that the same prerequisites are necessary to initiate the process of Rupee internationalisation. India did not opt for FCAC, we decided to go with the partial, obviously for our very own Central bank's priorities. But there were few external factors, like the IMF's decision, which also stamped the Indian partial account convertibility. In Dec 2012, the International Monetary Fund's (IMF) Executive Board endorsed a new "institutional view" on capital account liberalisation and the management of capital flows. The same institution that once emphasising on emerging markets and developing countries liberalising their capital accounts, has changed its view and now promoting the adequate regulation on the cross-border finance.

According to the IDG, size of an economy along with the scale of external trade has a direct bearing on internationalisation of its currency. Rupee certainly has a potential to become one of the international currencies as India is the fastest growing economies in the world and India's contribution in the global value chain integration is rising on an upward scale. The IDG recommends a set of time bound steps for the same.

Just like a domestic currency, an international currency performs the three functions of money – as a medium of exchange, a unit of account, and a store of value. Internationalisation of currency will bring direct and evident benefits to the country's private sector. Widening and deepening of domestic financial markets and instruments, offering larger base to the players in the market. Accessibility to international financial markets and funds at lower cost is another strong reason to go for it.

Internationalisation of currency comes with a price. There is going to be a tight rope walk for the monetary authorities, having to manage supply of country's currency to global demand on one side and the domestic monetary policy objectives on the other side. They both might come in conflict, popularly known as the 'Triffin Dilemma'. In case of infectious diseases, as you come in contact with the infected person, you are exposed to it completely and this is how the infection spreads. Similarly, internationalisation of currency would make economy more vulnerable to external shocks. (Which was also the case for FCAC). Additional demand formoney and rise in exchange rate, asset price volatility, is something that needs to be taken care of through the financial management aptitude.

Internationalisation of Indian Rupee has not come in the academic discussion off late. Research evidences show the previous brain storming on the same. Mohan, Patra and Kapur (2013) have identified four prerequisites for internationalisation of currency. They are as follows-

1. The reserve currency country should have deep and liquid financial and foreign exchange markets, which would facilitate the conduct of foreign exchange policies, manage currency risks effectively and support financial asset transactions denominated in the reserve currency.
2. Currency convertibility and a credible commitment to an open capital account to facilitate financial flows with minimal transactions costs; liquidity (narrow bid-offer spreads in normal and stress times); a full yield curve (to be able to manage duration and curve positioning); and depth, offering a range of products across different credit qualities (to achieve the desired level of credit risk).
3. Wide use in private sector transactions: a currency with a large share in world gross domestic product (GDP), trade and finance attracts more users and establishes network externalities. For example, if the country issuing the reserve currency is also a large exporter or importer, it could have the bargaining power to impose the use of its currency and increase acceptance of its currency. Further, such a

financially integrated economy typically enhances the breadth and depth of its domestic financial markets.

4. Macroeconomic and political stability: Policymaking institutions with credibility and a track record of maintaining price stability are critical ingredients to sustaining confidence in the currency's long-term purchasing power.

The IDG has given a detailed report and attempted an in-depth assessment of each one of the parameters/ issues related to internationalisation of Indian Rupee.

Various measures have been undertaken in recent times to promote the internationalisation of Indian Rupee- (i) allowing issuance of offshore Rupee-denominated 'masala' bonds; (ii) allowing domestic banks to freely offer foreign exchange prices to non-residents at all times, out of their Indian books, either by a domestic sales team or through their overseas branches; (iii) allowing Rupee derivatives (with settlement in foreign currency) to be traded in International Financial Services Centers (IFSCs); and (iv) an additional arrangement for invoicing, payment and settlement of export/import in INR has been enabled vide circular dated July 11, 2022.

Conclusion:

Along with the country specific core economic factors, there are number of geopolitical, international relation based factors which would influence and direct the process of de-dollarization. Apparently, at present there is no strong substitute for the US Dollar.

Looking at the country specific agenda's and movements, Country and currency-based clusters will get formed in specific regions/ continents as per their trade relations and financial market based requirements. Researchers are of the opinion that the currency internationalization could be a cherry on the top of any dessert dish. Before that five meal course has to be taken care of and that is the most challenging part of this currency internationalisation process.

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