Local Currency Settlement System

Why in news?

Recently, a MoU has been signed between India and UAE on Local Currency Settlement System.

What is the picture of India- UAE trade?

- India-UAE trade rose to USD 85 billion in 2022, making the UAE as *India's 3rd largest trading partner* for 2022-23.
- India's the *2nd largest export destination* and it is UAE's *2nd largest trading partner.*
- UAE accounts for 9% of its total foreign trade and 14% of non-oil export, it is the *7th largest FDI investor in India*.
- **Major imports-** In 2022, major imports were petroleum crude and petroleum products.
- **Major exports**-In 2022, major exports were petroleum products.

What is Local Currency Settlement System (LCSS)?

- Local Currency Settlement (LCS) means settlement of a bilateral transaction between two countries is conducted in the *respective currency of each country* where the settlement is conducted within their jurisdiction.
- The pact signed between UAE and India is to promote the use of the *rupee and UAE Dirham (AED)* for cross-border transactions.
- **Coverage**- It covers all current account transactions and permitted capital account transactions.
- **Mechanism-** It would enable exporters and importers to invoice and pay in their respective domestic currencies, this would enable the development of an *INR-AED foreign exchange market.*
- **Framework-** The RBI plan to settle international trade in the local currency which will let importers make payments in the rupee.
- The rupee will be credited to the special account of the correspondent bank of the partner country and the exporters will be paid from the balances in the designated special account.
- The Central bank is also in the process of issuing a *Standard Operating Procedure to all banks* so that e-BRC (electronic bank realisation certificate) becomes easy to use.

What are the advantages of local currency settlement system?

- **De-Dollarization-** It reduces the dependency on dollar payments for international transactions and strengthens the value of rupee.

- **Strengthen bilateral ties-** It is the reflection of mutual confidence and underlines the robustness of the economies and enhances the economic engagement between both the countries.
- **Increase economic partnership-** In 2022, India became the first country with which the UAE has signed a Comprehensive Economic Partnership Agreement (CEPA).

CEPA is the free trade agreement between India and UAE that was signed in 2022 and covers the trade in services and investment, and other areas of economic partnership.

- **Optimisation-** It would optimise transaction costs and settlement time for transactions, including for remittances from Indians residing in UAE.
- It could act as an important step in internationalisation of rupee.
- **Mitigate currency risk-** The use of the rupee in cross-border transactions mitigates currency risk and confers protection from currency volatility.
- **Foreign exchange** - It would enable the development of an INR-AED foreign exchange market.
- It will make India less vulnerable to external shocks as the need to hold foreign reserves will be reduced.
- **Competitive pricing-** As the use of the rupee becomes significant, the *bargaining power of Indian businesses* would improve.
- **Promote economic growth-** It leads to increase in the investment and remittances of both countries.

What are the challenges?

- **Rupee acceptability**- US dollar accounted for 60% of the global reserves and Euro accounted for 20% of the global reserves, the share of rupee in international market is very low.
- **Trade deficit-** If there is trade surplus we can invest the remaining amount in the country we trade with, but trade deficit is problematic.
- **Emerging NPAs-** Increase in non-performing assets in the banking system will affect the financial stability of the country.

What lies ahead?

- As recommended by RBI, a standardised procedure must be adopted to ensure local currency settlement system.
- There is a need to reduce trade deficit (by boosting the exports and improving the manufacturing sector) to leverage the benefits of local currency settlement system.

Quick facts

Other MoU signed between India and UAE

UPI-IPP Linkage

- MoU on Payments and Messaging Systems was signed for linking the Fast Payment Systems of the two nations.
- It aims to link the ***Unified Payments Interface (UPI) of India*** with the ***Instant Payment Platform (IPP) of UAE.***
- This will enable the users in either country to make fast, convenient, safe, and cost-effective cross-border funds transfers.
- It will link the respective Card Switches (*RuPay switch and UAESWITCH*).
- It will also explore the linking of the *Structured Financial Messaging System or SFMS* of India with the messaging system in the UAE.

References

1. PIB| UAE visit by PM
2. The Hindu| MoU on LCSS
3. Indian Express| Explained LCSS

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