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FX Insight

Defensive Shields in the Making

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Nations Want to Guard Against Further "Financial Weaponization"

ASEAN: From Local Currency Settlements to Transactions

The notion of encouraging greater usage of local currencies in Asia is not new and in fact had already been in set in motion. In Mar 2016, Malaysia and Thailand formed a local currency settlement framework in order to enable Malaysian and Thai businesses to use THB and MYR to settle trade transactions, joined by Indonesia later. This was a collaborative effort to encourage the usage of local currencies and to reduce reliance on the US dollar for trade and direct investments among the participating nations. We note slight convergence of the bid-ask spread for MYRTHB and MYRPHP since the start of the local currency settlement framework. There were still spikes seen in the bid-ask spread, especially during times of crisis (e.g Covid) for MYRIDR. Regardless, ASEAN has started to set up cross-border digital payment infrastructure that could pave the way for local currency transactions.

Russian Finance Minister Alexander Babakov announced that a BRICS common currency could be created, albeit without the confirmation from other BRICS member nations. A common currency could offer some benefits such as freer flow of trade within the same currency bloc. Apart from the usual pitfalls of a common currency, lingering geopolitical tensions between India and China present significant challenge for a common currency to be formed.

Has the RMB become more Internationalized?

China has long started the process of promoting the RMB. China's cross-border RMB settlement of trade on goods have been on the rise in the past three years with share of RMB settlement of total trade in goods above 20% compared to low 10% in 2018. On the other hand, its share of SWIFT payment remains low at around 2.2%. There could be a shift towards its own Cross-border Interbank Payment System. Meanwhile, growth of offshore RMB deposits is slow and foreign investors have been selling China's bonds. China's unwillingness to allow yuan to be freely convertibility and capital controls are the key hurdles for greater usage of RMB.

Shields are in the Making but USD Dominance is Hard To Erode

We observe that even as central banks continue to reduce the amount of USD holdings in their foreign exchange reserves, the DXY index gained. This could be due to the fact that at least 40% of SWIFT payments is still made in USD and emerging market economies still rely on USD-denominated debt. That may change with recent technology development in the payment system that gives renewed momentum for non-USD payments but there are still fundamental hurdles to cross for USD usage to fall significantly. Foreign holdings of USTs remain elevated and USD still dominates the foreign exchange market. USD bears as we may be, we cannot include the de-dollarization theme as one of the bearish drivers of the USD now. In fact, financial markets could still be vulnerable to USD liquidity risks and such episodes tend to drive the USD higher.

Hedging Against Further "USD Weaponization"

The topic of de-dollarization regained interests after a number of countries spoke about reducing dependency on the USD towards end of last month.

This is especially so at a time where USD has been on the decline as markets pare back expectations for further policy tightening by the Fed as the economy slows. Lingering signs of banking stress (with banks still tapping on emergency lending facilities recently).

For one, ASEAN Finance Ministers and central bank governors discussed about reducing dependence on the USD, EUR, GBP for financial transactions and to shift towards local currency settlements at an official regional meeting on 28 Mar. Around the same time, the BRICS nations were also in similar discussions. China and Brazil agreed to use their local currencies to conduct trade and financial transactions, potentially abandoning the USD as an intermediary.

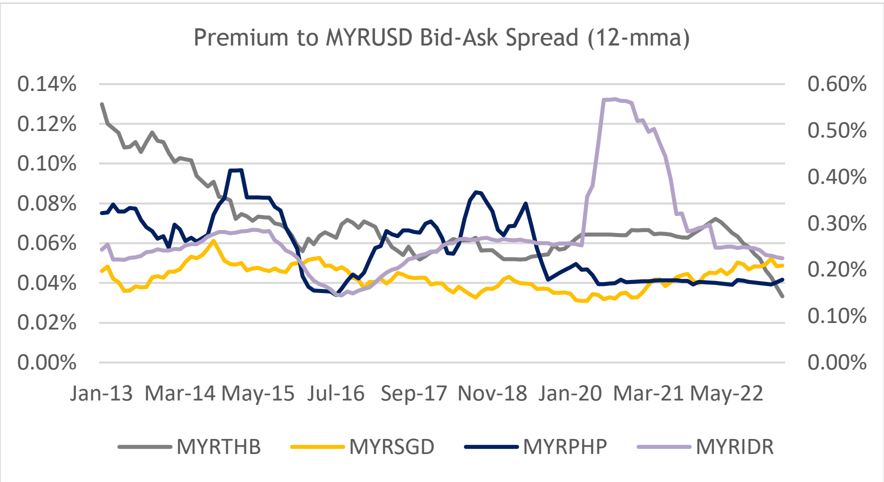
Our economics team colleagues have delved into the potential effects on the USD hegemony. In this piece, we take the opportunity to explore the existing local currency settlement agreements and how effective have they been in reducing transaction costs for merchants, the possibility and the hurdles to achieve a common currency and how far yuan internationalisation has come.

Local Currency Settlement Framework

The notion of encouraging greater usage of local currencies in Asia is not new and in fact had already been in set in motion. In Mar 2016, Malaysia and Thailand formed a local currency settlement framework in order to enable Malaysian and Thai businesses to use THB and MYR to settle trade transactions. This was expanded to cover direct investment in 2018 and Indonesia also joined the cooperative then. This was a collaborative effort to encourage the usage of local currencies and to reduce reliance on the US dollar for trade and direct investments among the participating nations.

The USD was the currency of trade and transaction of choice as it is very liquid apart from the fact that the US is a major export destination for many Asian countries. As a result of its liquidity, the exchange rate spreads for bank transfers between the USD and most local currencies in the region are normally much lower than that of other regional currencies.

Chart 1: Slight Convergence Between Bid-Ask Spread for MYRTHB, MYRPHP Towards MYRUSD



Source: BNM, Macrobond, Maybank FX Research & Strategy

Based on the data from Bank Negara Malaysia, there was indeed slight convergence of the bid-ask spread for MYRTHB and MYRPHP after the local currency settlement framework was set up. However, there were still spikes seen in the bid-ask spread, especially during times of crisis (e.g Covid) for MYRIDR.

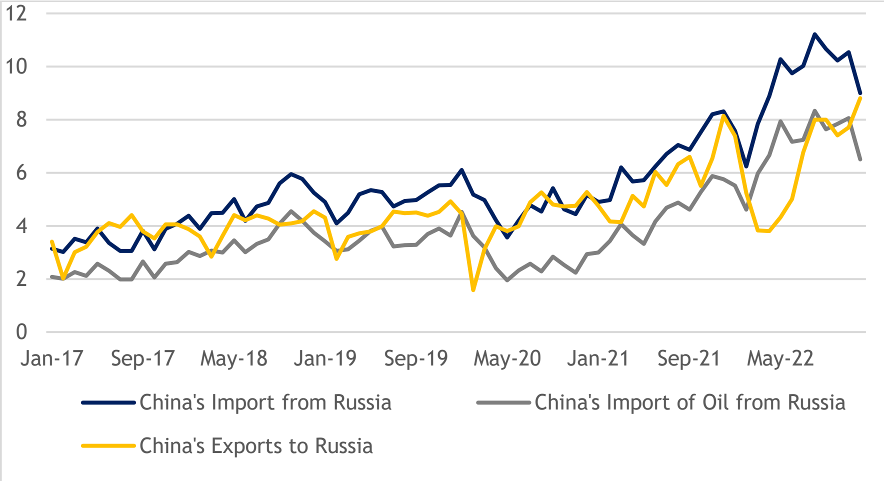
At the Mar ASEAN meeting this year, Finance Ministers and central bank governors gathered spoke about dropping the JPY, EUR, USD and the GBP from financial transactions and shift towards settlements in local currencies. This would be an extension from the current Local Currency Settlement scheme. In particular, Indonesia President Joko Widodo urged for a way to shield itself from geopolitical disruptions. China is still ASEAN's largest trading partner and any material sanctions imposed on China could be potentially disruptive to the region. As ASEAN struggles to hold the middle ground, **local currency transactions are now seen as a matter of ensuring some form of economic security** in a more fragmented world. The world is now vastly different from the birth of the Local Currency Settlement Framework back in 2016 when efficiency gains were the main draw, regional countries now see view the usage of local currencies with more urgency in light of the US-China trade war, Russia's invasion of Ukraine and rising export restrictions imposed on China by the US.

In Aug 2022, BI and Mas announced the start of work on a cross-border QR payment linkage between Indonesia and Singapore as part of the ASEAN-wide payments connectivity effort, target for launch in 2H 2023. This will enable instant, secure, efficient retail payments by scanning the QRIS or NETS QR codes displayed by merchants. Separately, BIS announced in Mar that it will also work with the central bank of Singapore, Malaysia, Indonesia, the Philippines and Thailand to connect their national payment systems through a cross-border payment gateway. Payments will be made with the use of only mobile phone numbers or the recipients company registration numbers. The aim is for transactions to be made within a minute. **The set-up of efficient cross-border digital payments could pave the way for local currency transactions to take hold within the region and to perhaps help the region to rely less on the Western-created financial infrastructure.**

BRICS Nations Are Most Motivated to Shift Away from the USD

Last year, we touched on the topic of RMB as a potential alternative to the USD here and came to a conclusion that it is not yet a good substitute. The motivation for that piece was driven by the sanctions imposed on Russia after its invasion of Ukraine. With around $300bn of Russia's foreign reserves frozen in Mar, some of its banks barred from the SWIFT messaging system and faced with multiple trade sanctions from the West, Russia had to turn to China as a market to sell its crude oil prices as well as to import semiconductors. **Trade between Russia and China flourished since with total trade having risen almost 29% in 2022 from a year ago.** Much of China's imports growth from Russia was driven by a 12%y/y increase in oil shipment while the biggest rise in Russia's imports from China were semiconductors and microchips.

Chart 2: Russia-China Trade Takes Off To Record High in 2022



Source: China General Administration of Customs (GAC), Macrobond, Maybank FX Research & Strategy

Last month, Putin declared that Russia is ready to use RMB in settlements between countries of Asia, Africa, Latin America, adding that he is sure that these forms of settlements will be developed between Russia partners and their counterparts in third countries. On 18th Apr, Bangladesh agreed to pay Russia $300mn in RMB for the construction of a nuclear power plant. However, there are also reports of how BRICS countries themselves are still a little apprehensive to transact in local currencies given that most are not fully convertible. Bangladesh was reportedly more comfortable with paying in RMB rather than the RUB but Russia, on the other hand, had originally requested for settlement in RUB. More recently, the Bank of Russia released a research report noting currency risks from settling their trade in the non-convertible RMB. In addition, there remains insufficient hedging tools available for RMB.

The rest of the BRICS nations had appeared to be motivated enough to reduce dependence on the USD.

Brazil has just rejuvenated its relations with China. President Lula and his ministers inked the accords with President Xi and his officials in Beijing, agreeing to boost investments and cooperations on technology and sustainable development along with supporting peace talk in Ukraine. They also pledged to *trade in local currencies* as opposed to the USD.

As of mid-Mar this year, the Reserve Bank of India allowed 18 countries to transact in the Indian Rupee through the use of Special Vostro Rupee Accounts (SVRAs). Importers and exporters can pay or be paid in rupees from these accounts. However, the Indian authorities were only in favour of pushing for the use of INR and had actually urged banks and traders ***not*** to use RMB to pay for Russian imports due to the geopolitical friction between the two nations .

South Africa had started using yuan years ago with SWIFT reporting a surge in yuan payments when China in 2015. While trade between the two countries continues to grow, China has been accused of deliberately lending to countries that it knows cannot repay so as to extend its soft power. So China has been practicing quite a bit of debt forgiveness for South Africa.

Forming A BRICS Common Currency is Challenging

Amid reports of Russia selling the non-convertible yuan in exchange for Western currencies this year, Russian Finance Minister Alexander Babakov announced that a

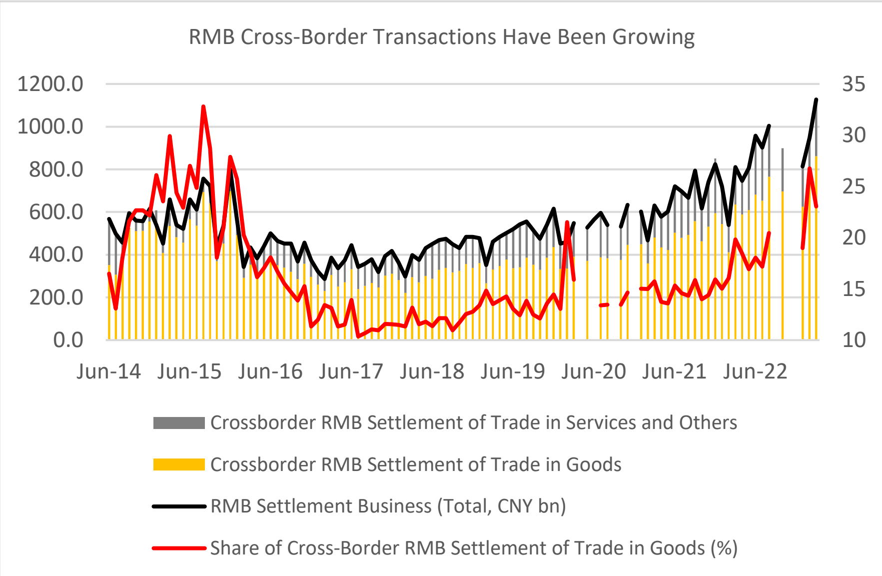
BRICS common currency could be created, albeit without the confirmation from other BRICS member nations. A common currency could offer some benefits including freer flow of trade within the same currency bloc.

On the other hand, there could be some serious challenges to form a common currency for the BRICS in our view given the *existing geopolitical tensions* between India and China. In addition, the economic conditions of each country are rather different from each other and there could be a significant hurdle in formulating a somewhat uniform economic policy that can be suitable for all. *Weaker countries may be left more vulnerable to negative external shocks* without the autonomy of setting their own monetary policy. China is the biggest consumer of resource exports from Brazil, South Africa and Russia and *design of a common currency may potentially be skewed in favour of the stronger country (s).* Afterall, China is the country with a trade surplus and significant forex reserves. In the case of the Euro, Germany was the stronghold and the creation of EUR benefitted German exports. The resultant trade surplus continued to support the EUR but could render exports of other countries as less competitive. Last but not least, there needs to be a free movement of capital, labour between the members within the zone for countries to reap the benefits of a common currency zone and China is not likely ready to ease its capital controls in the near term.

So, shifting towards an alternative currency such as the RMB is still the more viable option in the interim for other BRICS nations.

Is RMB more Internationalized?

Chart 3: Cross-border Settlement of Trade in RMB Recovers



Note: Gaps are due to unavailable data during the pandemic.

Source: PBoC, China Customs Statistics Information Centre, Macrobond, Maybank FX Research & Strategy

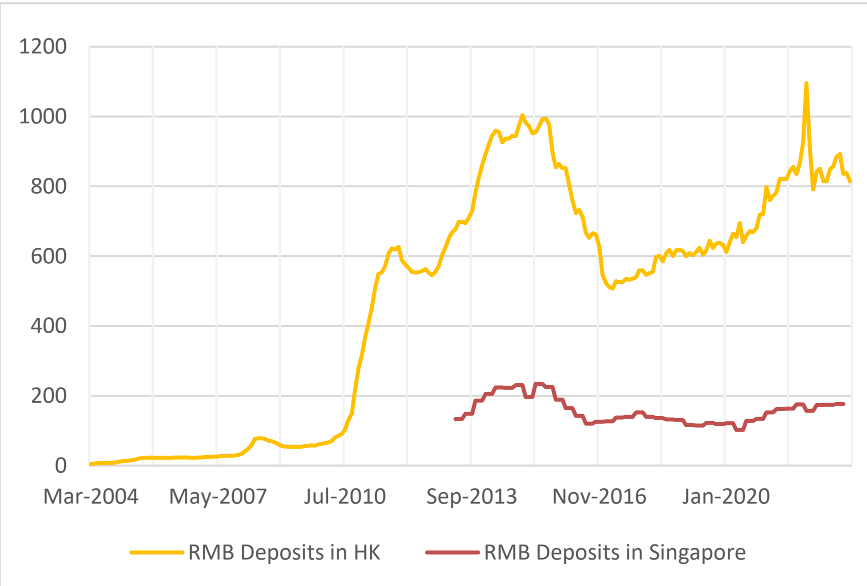
With China being the second largest economy and a giant of a trading partner for most countries, there should be a natural increase in the use of RMB for transactions and settlement. Based on PBoC data, China's cross-border RMB settlement of trade on goods have been on the rise in the past three years. The one-off devaluation in the RMB in 2015 that was followed by quite a bit of RMB volatility and capital outflows actually dampened the use of RMB at one point (as seen in the chart above) but cross-border settlement in RMB as a share of China's total trade in goods has risen back above 20% but is not near the peak of what was seen in early part of 2015 yet.

Meanwhile, its share of SWIFT payment remains low at around 2.2% and there was little growth in the past decade. China has been developing its own Cross-border international payment system (also known as CIPS). According to Yeung and Goh's (2022) estimates, 80% of payments through CIPS use SWIFT messaging (direct participants such as banks use CIPS messaging system while non-direct participants of CIPS rely on the SWIFT). That may have shifted as Russia's trade with China could be largely via the CIPS messaging system now. The growth of cross-border RMB Settlement does not match RMB's share of SWIFT payment and that could mean that growth could be happening via CIPS. China now has 79 direct participants as of Mar 2023 vs. 33 in Feb 2020.

One key development that could enable RMB usage to circumvent SWIFT is the e-CNY, China's own digital currency that is issued by PBoC directly – also known as the Digital Currency Electronic Payment which can also allow individuals to make payments offline. Cross-border payment using the e-CNY has been in trial since last year. A BIS report indicated that e-CNY was the most issued, actively transacted token in a $22mn 6-week pilot test (part of m-Bridge) that used central bank digital currencies to settle cross-border trades. Earlier this year, e-RMB was also used to buy securities. The pilot tests of CBDCs could pave the way for countries to fall back on the CBDCs should the geopolitical conflict escalate and disrupt trade.

A key reason for some hesitance to receive/pay in RMB is in its lack of convertibility. Earlier this month (Apr 2023), PBoC Yi Gang said he "does not have a date" for when RMB could be made freely convertible. Focus instead at this point, is to "enhance the ease of the use of the currency".

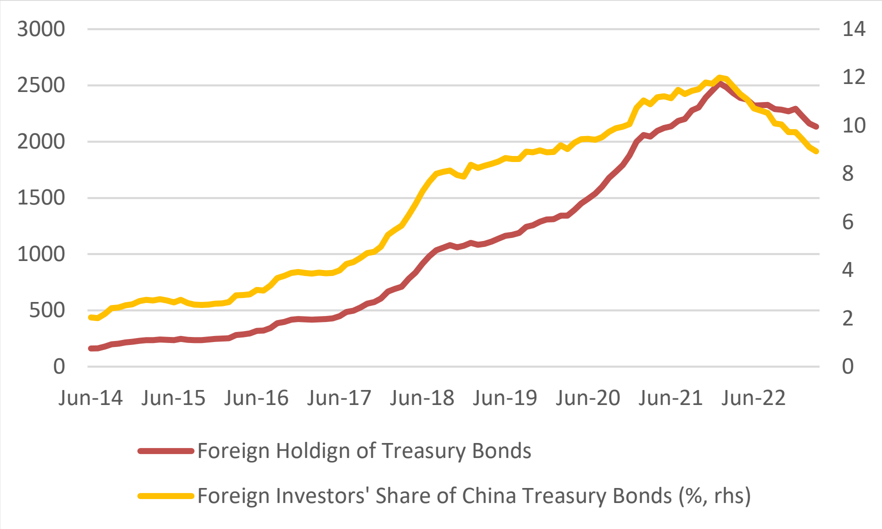
Chart 4: Offshore RMB deposits Have Been Stable



Source: HKMA, MAS, Macrobond, Maybank FX Research & Strategy

In addition, offshore RMB deposits have been stable in Hong Kong as well as in other parts of the world like Singapore, with little sign of resuming its exponential growth around 2010. In the meantime, foreigners have been selling Chinese bonds. Foreign ownership of Chinese treasury bonds have dropped to under 10%. A lack of interest in China's assets at this point may also dim the allure of using the RMB as a store of value, particularly in an inflationary environment.

Chart 5: Foreign Investors Have Been Selling Chinese Bonds



Source: ChinaBond, Macrobond, Maybank FX Research & Strategy

Its lack of convertibility and depth of liquidity could be the key hurdle for countries to hold/pay/receive RMB.

Yi Gang's recent words suggest that yuan's convertibility status is not likely to change soon. Cross-border payments via e-CNY does not remove the existing challenges for RMB to be more broadly used and held. China's unwillingness to ease capital controls more meaningfully as well as a lack of convertibility of the RMB could also mean that cross-border payments by e-CNY could just be a back-up plan or at the very most restricted.

The US Dollar's Dominance Will Not Fade So Soon

Similar to our economics colleagues we are of the view that the USD will not "wither and die" anytime soon even as more countries opt for an alternative currency for trade settlements and form common currencies. Back in 1999, when the Euro was born, the 11 member nations of the EU that met the euro convergence criteria became the Eurozone and used the new "Euro" currency contributed 20% to the world GDP. While this was still lower than the US' (at around 30%), it was nonetheless substantial. The Euro was only actively used three years later in 2002. Since then, the USD's share of forex reserves held by central banks have declined. We cannot say for sure that a common currency zone formed by BRICS or ASEAN can have the same effect.

At present, ASEAN's share of the world GDP remained comparatively low and as such less threatening to the USD's hegemony even if local currency transactions take off. However, ASEAN is fast growing so that could change in the future. BRICS nations on the other hand has a more comparable GDP size to the US now, largely due to China and to a fair extent, India. However, we have covered that common currency formation there could be challenging.

In the past decade, central banks have started to diversify their forex holdings towards other currencies such as the CNY, AUD and CAD. CNY's share of forex holdings is very disproportionate to the size of its trade with the rest of the world as well as its GDP. Nonetheless, the shift towards other currencies such as the CNY, CAD and AUD underscores a desire to diversify away from traditional hard currencies.

Chart 6: Share of World GDP

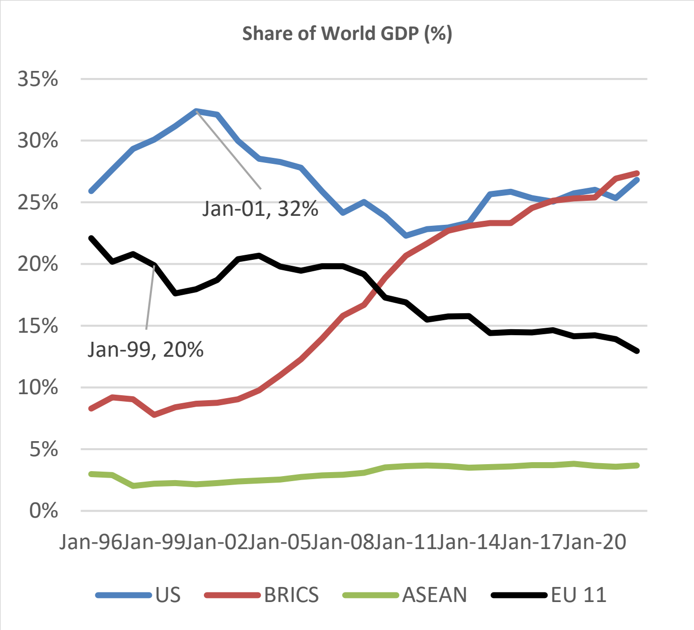
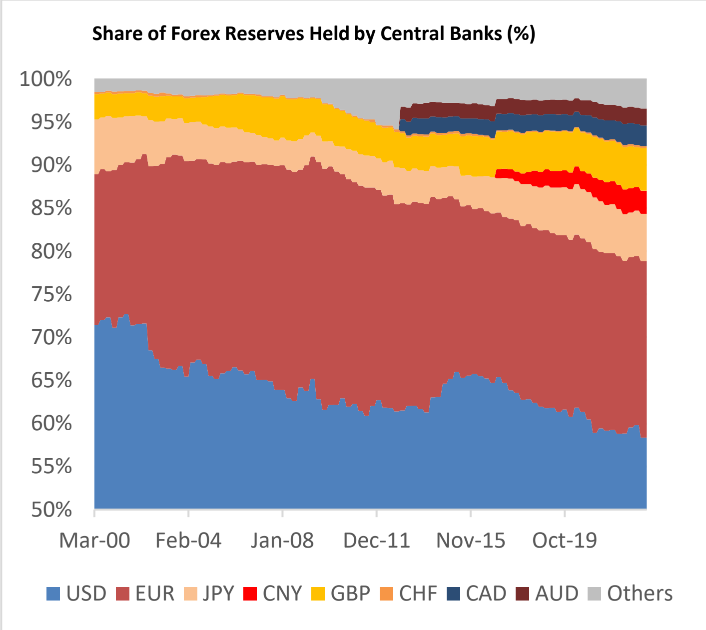


Chart 7: Share of Central Bank Foreign Exchange Reserves For Each Currency



Source: World Bank, IMF COFER, Maybank FX Research & Strategy

Even as USD share of Forex Holdings Decline, Share of USD Payment is Stable

For much of the past two decades, we see the DXY index tracking the US Dollar's share of forex holdings by central banks. However, that relationship has broken down in 2018. Even as central banks continue to reduce the amount of USD holdings in their foreign exchange reserves, the DXY index continued to appreciate. This could be due to the fact that at least 40% of SWIFT payments is still made in USD (and remains somewhat stable around that level for much of the past decade) and emerging market economies still rely on USD-denominated debt.

Chart 8: USD strengthens even as Central Banks Diversify Away from the USD

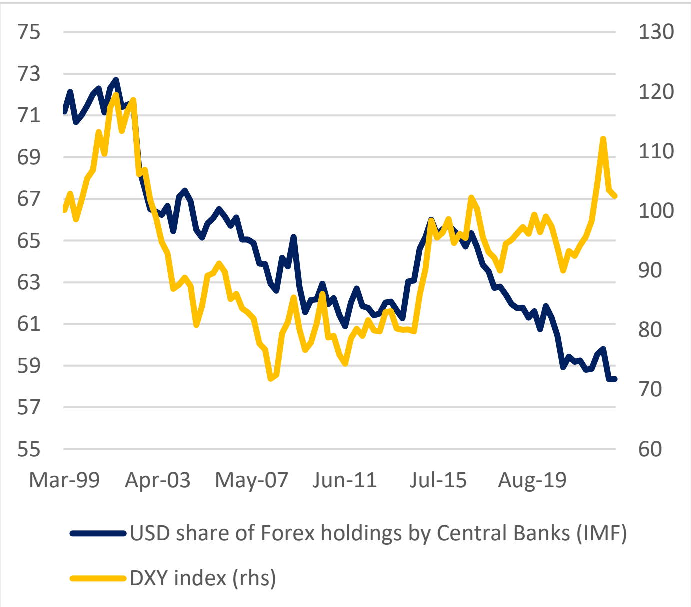
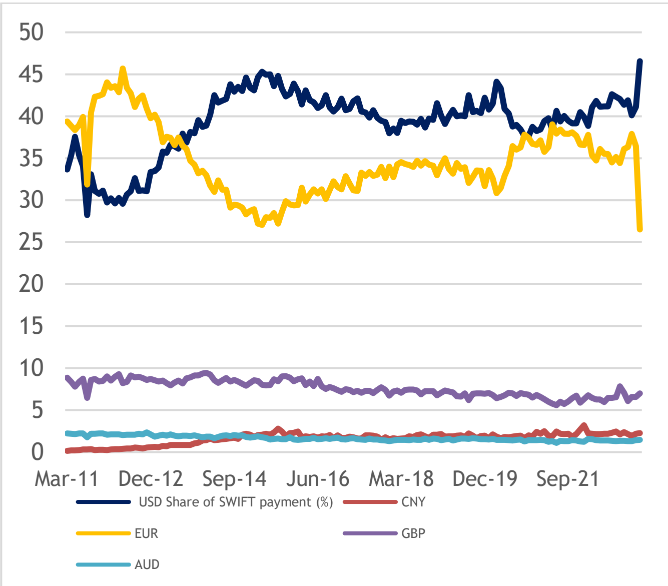


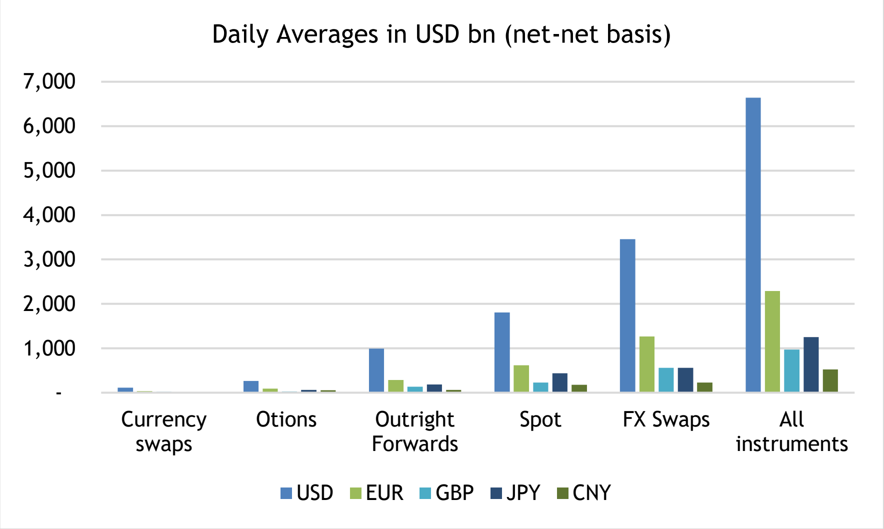
Chart 9: USD Share of SWIFT Payment Jumps, Remains Above 40% For Much of the Past Decade



Source: IMF COFER, SWIFT, Bloomberg, Maybank FX Research & Strategy

BIS triennial survey for 2022 showed clear dominance of the USD in the foreign exchange market for all instruments. FX swaps which are typically used for currency risk hedging and liquidity management are the most traded with the USD turnover at around $3.6 trn, 91% of the total daily turnover of $3.8trn.

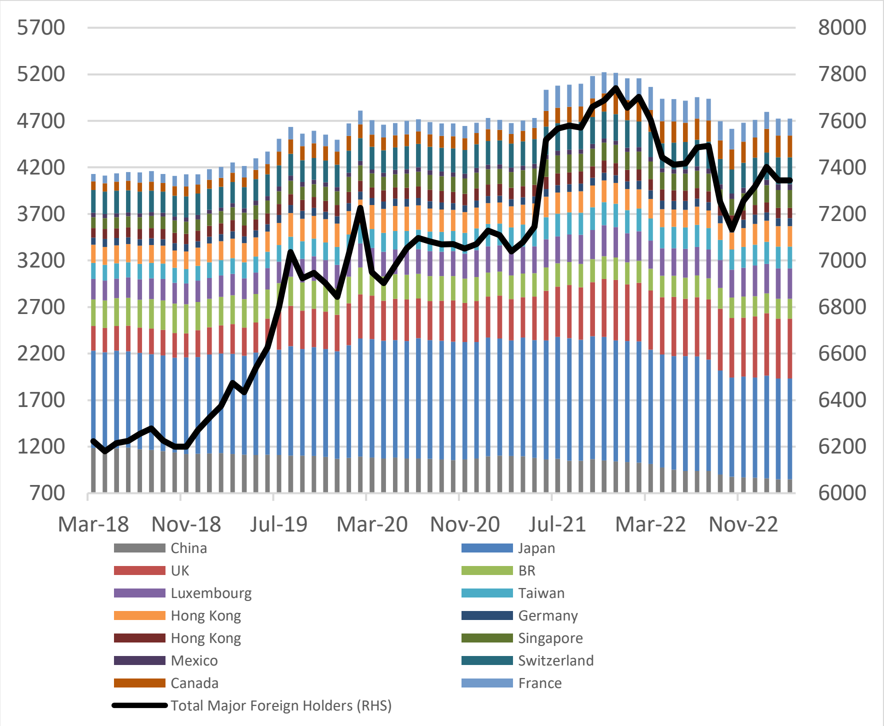
Chart 10: USD Still Dominates in the Forex Markets



Source: BIS Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Market

Meanwhile, even as notable countries like China reduced their UST holdings in recent years, total foreign holdings of USTs continue to remain elevated.

Chart 11: Foreign Holdings of USTs Remain Elevated



Source: US Treasury, Maybank FX Research & Strategy

De-dollarization requires more than just a significant decline in central bank reserves. The recent rise of digital payments could pave the way for local currency transactions in ASEAN but the process of constructing such shields from the "USD weaponization" is still at an early stage and requires immense intra-region cooperation. This theme, as exciting as it seems at this point, could take years to play out. USD bears as we may be, we cannot include the de-dollarization theme as one of the bearish drivers of the USD in the near-term. In fact, financial markets could still be vulnerable to USD liquidity risks and these episodes could still drive the USD higher.

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