EMERGING MARKETS ECONOMICS UPDATE

How feasible is a BRICS currency?

- **The idea of a new BRICS currency to settle trade or hold in reserves instead of the dollar has been doing the rounds recently. This could be modelled on the IMF's Special Drawing Rights. But getting India on board with China would be difficult. And if the goal is to push back against the hegemony of the dollar, a new shared currency would offer no advantages over existing national currencies, which themselves are making only limited headway.**

- The importance of the dollar gives the US enormous power over global trade and financial flows. Increasingly it has been wielding that power. Most starkly, the US imposed heavy financial sanctions on Russia in the wake of the war in Ukraine. In doing so, it exposed how much other economies' international transactions are dependent on the mercy of Washington.

- That has spurred a new push, particularly by geopolitical adversaries of the US, to push back against the hegemony of the dollar. **One idea that has surfaced in some quarters is the creation of a new currency by the BRICS (Brazil, Russia, India, China, South Africa)**. Perhaps unsurprisingly, the most vocal advocate have been Russian, with backers including President Vladimir Putin and Foreign Minister Sergei Lavrov. But Brazil's President Lula has also recently voiced his support.

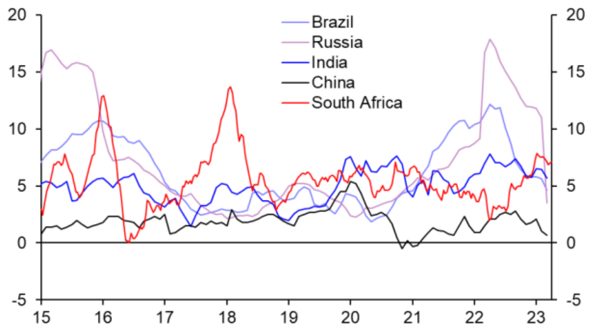
- **It's not clear what these policymakers have in mind when talking about a BRICS currency. It may even be that they are referring to different things.**

- **One extreme end of the possibilities is a monetary union of national economies, like the euro-zone. This is a non-starter. Leaving aside the political barriers, the economics doesn't work**. The one factor in favour is that the business cycles of China and the other economies – other than India – are at times roughly in sync, thanks to the link provided by China's commodity demand. As a result, tightening and loosening phases by their central banks often coincide. But the other economies are subject to far bigger swings in inflation than China. (See Chart 1.) A cursory glance at policy rates shows that the appropriate monetary policy stance usually differs massively too. (See Chart 2.) And over the past year, there has been no synchronisation at all, with the People's Bank loosening against a backdrop of tightening elsewhere.

- The BRICS grouping falls a long way short of an optimal currency area in other respects. Labour mobility is constrained by geography (roughly 15,000km of sea and land separate Russia and Brazil). Capital cannot flow freely given capital controls of varying degrees in Russia, India and China.

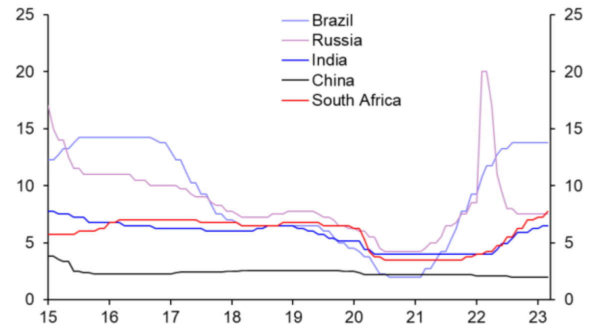
- **A less extreme and more feasible option would be the formation of a "BRICS currency" reserve asset, similar to the IMF's Special Drawing Rights (SDRs)**. One way this could work would be for each country's central bank to be issued "BRICS currency" assets constituting a claim on the other central banks. For each central bank, the value of their new asset would be matched by the value of the liability formed by the other central banks' claims.

Chart 1: Headline Inflation (% y/y)



Sources: Refinitiv, Capital Economics

Chart 2: Policy Rates (%)



Sources: Refinitiv, Capital Economics

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- The value of the new asset would track a basket of the underlying domestic currencies. It could supplement existing reserves and, in principle, be used to help importers settle trade in the new currency, rather than in the dollar, real, rupee, ruble, rand or renminbi.

- **Getting India on board with any of this would be difficult. Diplomatic relations between India and China are arguably even more frayed than they are between the US and China**. India has a contested land border with China where tensions have spilled over into military skirmishes. India's government has been trying to reduce China's economic leverage. For example, India has taken one of the hardest lines against Chinese-created apps of any country and has joined the US and many of its allies in barring local telecoms from using Huawei and ZTE equipment for 5G networks.

- **India's absence wouldn't preclude the formation of a new currency by the other economies** (though the lack of a vowel would hurt – BRCS?). But even then, a new reserve currency would not improve on the status quo. There might be some small benefit to Russia from gaining access to new reserve assets since half of its FX reserves have been frozen by Western governments. But the others already have plenty of reserves. (Our preferred measure of reserve adequacy – reserves relative to the gross external financing requirement – is shown in Chart 3.)

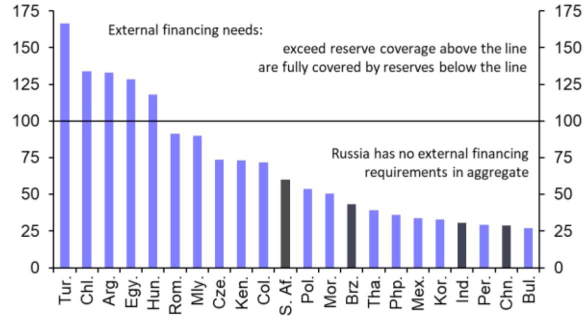
- **As for creating a new currency to settle trade, there are two major problems. The first is that trade within the BRICS bloc is not balanced. India and South Africa have each run persistent deficits with their BRICS partners since the turn of the century**. (See Chart 4.) If all bilateral trade were settled in the new BRICS currency, India and South Africa would run out of reserves unless they received counterbalancing investment inflows in the new currency from other BRICS economies.

- **The second flaw is that attempting to settle trade in a new currency introduces a new complication into transactions where the dollar's great draw is simplicity**. Individual exporters typically don't want to receive revenues in dollars, but they don't mind because the global market for dollars is so large and liquid that it is cheap and easy to convert dollars into domestic currency. **The drawback for a Brazilian exporter of receiving payment in renminbi is that converting renminbi to real is harder than it is to convert dollar receipts to real. It would be even more cumbersome to offload revenues received in "BRICS currency" for which no liquid market currently exists.**

- And without a domestic issuer of "BRICS currency", a liquid market could only ever exist if the participating central banks agreed both to issue massive amounts and to act themselves as market markers willing to buy and sell the new currency at bid-ask spreads equivalent to those in Treasury markets. **A new currency that only existed as entries on BRICS central bank balance sheets would be a dead end**. This is the other parallel with SDRs: envisaged as a dollar replacement, the lack of a liquid market for them or an institution willing to create a market in them has doomed them to (near) irrelevance.

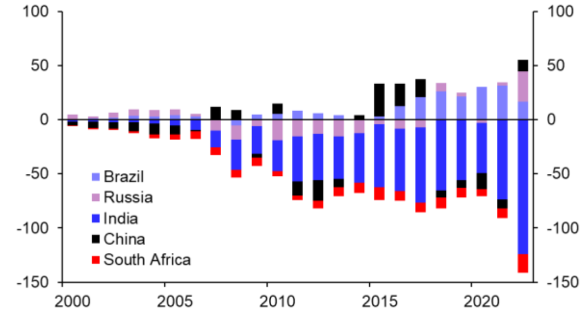
- In sum, a BRICS currency wouldn't solve any of the problems that make moving away from the dollar hard, and in some ways would make those problems worse. Existing domestic markets in real, rupee, ruble, rand or renminbi assets makes these more plausible alternatives for settling trade. And currency swaps between BRICS central banks are a simpler means to the end of boosting access to deployable reserves. Even the renminbi though, the most plausible of the ("R5") currencies to operate as a vehicle for intra-BRIC trade, will fail, we think, to become a meaningful challenger to the dollar.

Chart 3: Gross External Financing Requirement (% of FX Reserves)



Sources: Refinitiv, Capital Economics

Chart 4: Goods Trade Balance with the Rest of the BRICS (US$bn)



Sources: Refinitiv, Capital Economics