Would gradual de-dollarization boost trade?

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With trade at the forefront of global political discourse, is it time to reexamine the dominance of the US dollar and move towards more local currency financing?

The fairness, sustainability and benefits of global trade have moved centerstage in global political discourse. Protectionism is on the rise and the multinational approach to solving disputes has been brought into question. One important aspect of global trade is that it is mostly denominated and financed in US dollars and a few other hard currencies. The vast majority of the US$ 2.3 trillion transaction volume insured by the Berne Union members in 2017 was denominated in hard currency. This dominance of hard currencies, and of the US currency in particular, has been accepted almost as a natural condition.

However, there is enough evidence of negative side effects. A recent IMF Working Paper[1] showed that whenever the US currency appreciates against the rest of the world by one percent, a 0.6 to 0.8 percent decline in global trade is predicted within the next year. In terms of trade, there is a clear relationship between the importers' and exporters' currency against the dollar exchange rate but not their bilateral exchange rate. For example, A Rwandan exporter to India may suffer because his or her clients will consume less because the price of the import measured in the currency they earn income has become more expensive. Both the Rwandan exporter and the Indian importer/consumer are exposed to US policies and the ongoing tightening cycle of the US Federal Reserve. To make matters worse, the Fed still has a long way to go (in particular against the background of expansionary US fiscal policy), which will further push up the value of the dollar.


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Moreover, speculating that importers will be able to come up with hard currency is a risky bet. During the Azerbaijani currency crisis, the manat plummeted 100% within 12 months following the steep decrease in oil prices and exports. With liabilities denominated in US dollars there were numerous defaults. Turkey and Argentina are more recent examples, with all consequences on loan portfolios not yet fully known. For sure, currency risk makes total costs of funding more expensive in terms of credit margins. Based on the experience from other sectors, local currency financing (combined with more comprehensive hedging strategies) improves the repayment capacity of debtors/importers during periods of currency volatility and should reduce total trade financing costs.

The question arises whether global trade would benefit from increasing the share of trade denominated and financed in local currencies? Aside from reducing collateral damage of tightening US monetary policy, it would also improve the sustainability and costs of trade financing. Such policy considerations are already more advanced in the area of development finance, where policies to actively promote local currency financing are already discussed at G20, and at other very senior policy making levels, in the context of achieving SDGs in a financially and socially sustainable way.

For the Berne Union and its members, a first practical step might be to rigorously analyze their own data to quantify how much currency risk had contributed to claims and defaults. Armed with this evidence, a bigger effort to advocate local currency financing could be contemplated.

Most necessary conditions to start local currency financing programs are already in place. Opportunities to finance and denominate trade in local currencies in adequate amounts are increasing, even in the most exotic frontier countries. Local and international currency risk markets are growing in depth and tenors. Today, currency risks in almost all emerging and frontier market currencies can be hedged. TCX is offering hedging tools for periods of 15 years or even longer in more than 70 frontier and emerging markets (Box TCX). We are very pleased to work together with the Bern Union, its members, and commercial banks to develop new local currency solutions.

The shift towards financing international trade in local currencies is a business opportunity for the Berne Union members and gives their own clients a competitive advantage. A first case is to better understand and explore a business case to insure transactions in local currency. In principle, BU members can reduce their own currency risk from providing insurance to local currency financing by asking for the premium to be paid in local currency, hedging themselves and locking in claims at the exchange rate of the date of invoice or the day of the contract. Furthermore, we need to improve risk awareness and how best to manage currency risks. This is a challenge especially for the communications department that publish newsletters, blogs, etc.

Improving the sustainability and fairness of global trade is a noble goal. Reform efforts should also include underlying financing conditions. Today's market can provide local currency financing in rapidly increasing volumes. This opportunity should be recognized and used for the better of global trade and international development. Putting all the currency risk on the shoulders of producers and consumers in developing countries does not seem the most effective solution. ■

Note

1 Source: Global Trade and the Dollar, Emine Boz et al. ,IMF Working Paper WP/17/239 2017.

About TCX

The Currency Exchange Fund (hereafter TCX) was founded in 2007 by a group of development finance institutions, microfinance investment vehicles and donors to offer solutions to manage local currency risk in developing and frontier markets. It also benefits from strong support from both the Dutch and German government.

TCX plays an important catalytic role in the development of capital markets by taking currency risks private markets and commercial banks would not take. Today, TCX offers currency risk protection for 15 years or longer in almost 80 frontier and emerging market currencies. Ticket sizes vary from less than US$1mln to as much as US$150mln. Since inception, TCX hedged almost USD 6 bln of local currency loans in almost 60 different currencies.

TCX offers hedges in frontier currencies for any counterparty which is deemed to add development impact to a local economy. For a typical transaction TCX would receive local currency and pay hard currency for the duration of the derivative contract on a non-deliverable basis. Via this mechanism TCX enables its clients and shareholders to match their revenues with their liabilities and mitigate most of the forthcoming exchange rate risk.

TCX manages its own currency risk by (a) diversifying over a very large portfolio with strict single currency and regional limits; and (b) having a rigorous risk quantification and pricing framework which allows us to learn and gradually improve the quality of our pricing. To stimulate capital markets and manage its own portfolio TCX was even able to support more than 17 bond issuances of its shareholders in local currency including Myanmar, Armenia, Georgia and Ukraine.

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