

# Would Gradual De-Dollarization and More Financing in Local Currencies Boost Trade?

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## Abstract

The article summarizes arguments in favor of de-nominating trade finance in local currencies. By reducing exposure to policy developments in reserve currency countries and improving the allocation of currency risk with the help of global currency risk markets will have a positive long-term impact on stability, trade volumes, and growth.

The fairness, sustainability and benefits of global trade have been moved centre stage in the global political debate. Protectionism is on the rise and the multinational approach to solving disputes has been put into question. Against this increasingly conflictual background, one important aspect of global trade has received relatively little attention. Today, global trade is mostly denominated and financed in US dollars and a few other hard currencies.

The dominance of hard currencies, and of the US currency in particular, has of course historic and good reasons. In past decades there were simply no or very few alternatives to financing trades in hard currencies. Adequate long-term loans in emerging market or even frontier market currencies were simply not available on a reliable and adequate basis. Today, this situation has fundamentally changed and long-term loans in local currencies are increasingly becoming available. Eichengreen et al, (2012) have pointed out that history suggests that network externalities, first-mover advantages and inertia matter, but they do not lock in international currency status to the extent previously thought. A shift away from a unipolar dollar-based system could occur sooner than often believed, driven by local financial market deepening and stability oriented macro-prudential policies and tools.

This brief contribution makes the case that we should build on the existing momentum to strengthen such driving forces and gradually shift trade financing into local currencies. In this effort, the export credit agencies (ECAs) and development finance institutions (DFIs) will have an important catalytic role.

## The advantages of local currency financing

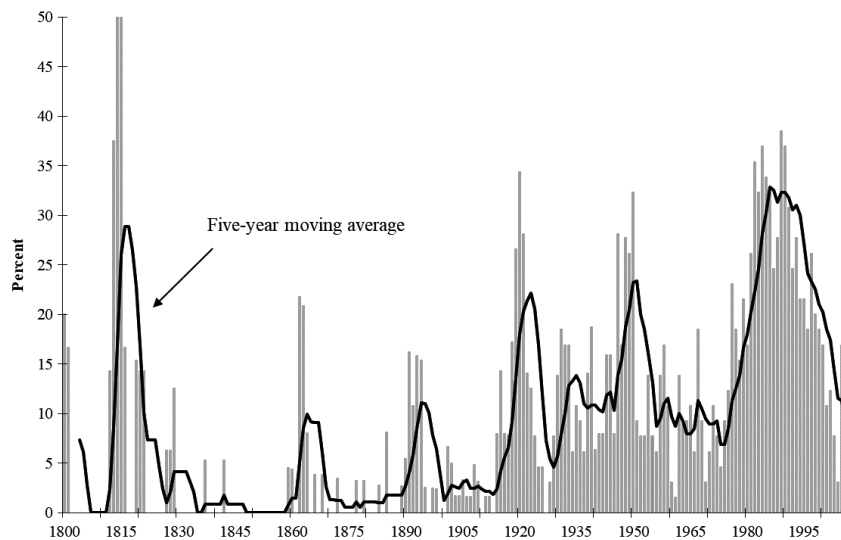
There is increasing evidence of negative side effects of trade dollarization. Boz et al. (2017) pointed out that whenever the US currency appreciates against the rest of the world by one per cent, a 0.6 to 0.8 per cent decline in global trade is predicted within the next year. There is a clear and strong relationship between trade prices and the dollar exchange

rate but much less with the bilateral exchange rate between importers and exporters. For example, a Rwandan exporter to Kenya may suffer because Kenyan clients will consume less because the price of the import measured in the currency they earn as income has become more expensive due to events in the US. Putting it differently, by using the US dollar as common denominator, both the Rwandan exporter and the Kenyan importer/consumer are unnecessarily exposing themselves to shocks and policies in the US. Such deference to a third party may make sense when this party is perceived as acting as global guarantor of an international, global trade system, but may make less sense if the third party very explicitly puts its own national interests first. Such considerations are especially relevant amidst the ongoing tightening of the US Federal Reserve to fight inflation against the background of a strong economy, record low unemployment and continuing strong fiscal impulses, including massive increases in US government spending.

There is also an important sustainability argument in favour of local currency financing. It has to do with risk perception and management capacities, both on the individual firm and the macro(-prudential) level. Currency depreciation risks are often underestimated. Observers too often look at the immediate past. In contrast, if Reinhart and Rogoff (2008) showed that currency depreciations of more than 15 per cent have occurred with worrying frequency (Figure 1).

The big advantages of local currency financing are (1) that it makes macro risks more transparent and (2) it shifts the exchange rate risks away from the borrowers. Local currency interest rates incorporate a premium to compensate domestic and foreign investors for inflation and depreciation risks in the local currencies in which funded projects, firms, and households earn their income. Because of enhanced risk awareness, borrowers and investors have a better chance to avoid unprofitable and unsustainable investments. This informational advantage even holds, if borrowers should ultimately still decide to speculate and expose themselves to currency risk by borrowing in a foreign hard-currency, as long as a sufficiently transparent local currency yield curve

**Figure 1.** Currency crashes: the share of countries with annual depreciation rates greater than 15 per cent, 1800–2007.



Source: Reinhart and Rogoff, 2008.

exists. Exporters and export credit providers will be less exposed to default risks.

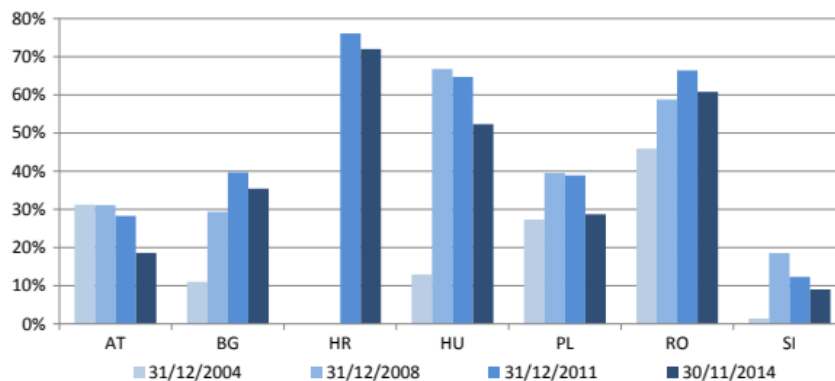
**Policies supporting local currency funding gain momentum**

Some regulators are trying to limit lending in foreign currencies and boost local currency funding for consumer protection and macro-prudential reasons. For example, the European Systemic Risk published in 2011 a Recommendation on Lending in Foreign Currencies, especially to curb foreign currency lending in Eastern European countries. It recommended to limit exposures to credit and market risks and increasing the resilience, control excessive foreign currency credit growth and create incentives to improve risk pricing associated with foreign currency lending. The ESRB requested national supervisory authorities to require financial institutions to provide their borrowers with sufficient

information to understand risks involved and take a well-informed decision and encourage financial institutions to offer domestic currency loans for the same purposes as foreign currency loans as well as financial instruments to hedge against the risks involved. After these Recommendations were published, household foreign currency borrowing declined noticeably as a share of total loans (Figure 2).

The mitigation of currency risks is also moving centre stage in the global policy debate how to finance the Sustainable Development Goals. This agenda is often referred to as *moving from billions to trillions*, which reflects the ambitious scaling up of financing flows to developing countries to achieve the SDGs. History has shown that massive inflows destabilize recipient countries, especially if domestic institutions are weak. Reinhart and Rogoff (2008) documented the link between capital inflow booms, so-called capital flow bonanzas, and subsequent busts and sovereign default: all of the six major spikes in new defaults from 1800

**Figure 2.** Household foreign currency loans in selected CESEE countries, as a share of total loans.



Source: ECB and ESRB calculation.

to 2016 occurred after a global capital inflow bonanza ended. SDG financing flows would constitute a capital flow bonanza. After a comprehensive historic analysis of 48 debt crises, Dalio (2018) concluded that downside risks of having a significant amount of debt depends a lot on the willingness and the ability of policy makers to spread out losses arising from bad debts which depends on two factors: 1. whether the currency is denominated in the currency they control and 2. whether they have influence over how creditors and debtors behave with each other. To maximize and sustain a long-term development impact, SDGs need to be financed in sustainable way. Therefore, improving the allocation and management of currency risks and increasing the share of development and trade financing denominated in local currencies seems a step in the right direction.

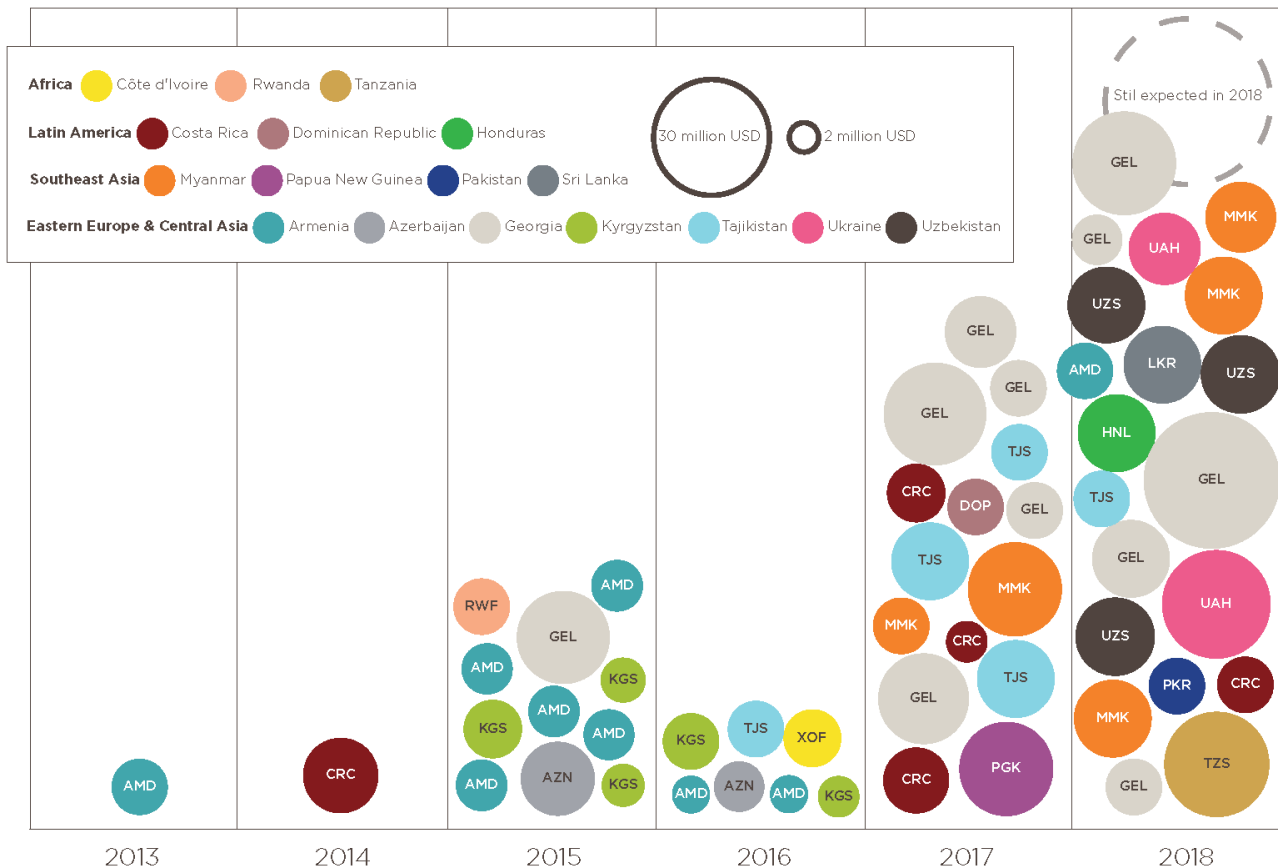
### Accelerating growth in local currency markets

Local currency funding via local currency loans and local currency bonds is accelerating and has reached acceptable volumes. Developments in individual countries can, however, be very uneven. The picture in the loan markets is not very clear, due to absence of good comprehensive statistics. Development lenders, including DFIs, Multinational Development Banks, and specialized funds have increased their

offering of local currency loans, even to their clients in the poorest countries. Their hedging requirements as experienced at TCX are increasing steadily, reflecting the growth in their underlying local currency loan business. Moreover, an increasing number of local currency lending vehicles has been emerging. Other partial statistics also support the view of noticeable growth, but a more comprehensive aggregate assessment would be useful.

The data situation for bond financing seems better. Local currency bond markets are increasing in most parts of the world (IMF and World Bank, 2018). As of 2016, 88 per cent of outstanding emerging market debt was issued in local currency bond markets, with a total volume of US\$20 trillion (up more than 50 per cent since 2011). The report also highlights that emerging and low-income countries are attracting non-resident investors and extending maturities. In Africa, for example, countries such as Ivory Coast, Namibia, Senegal and Uganda more than doubled the issuance of local currency government bonds between 2009 and 2014, with the stock of local currency bonds in these countries now on average equivalent to 8.5 per cent of GDP. The maturity of bonds issued between 2009 and 2014 rose on average from 1.5 years to 6.4 years, with some counties such as Ghana, Kenya, Namibia, Nigeria, and Tanzania issuing local currency bonds in maturities over 15 years. The emergence of blended finance vehicles

Figure 3. Exotic currency bonds primary issuance volume.



to support local bond markets, such as the Africa Local Currency Bond Fund will contribute to widening this growth to the poorest countries.

Markets for currency risk hedging instruments, especially swaps and forwards are growing fast in parallel to local currency loan and bond markets. The greater availability of hedging instruments gives investors and borrowers additional flexibility to manage and focus the risk profile of available investments to better match their risk appetite. For example, an institutional investor would like to have the bond of an investment grade issuer in denominated in an exotic currency, others may seek exposure to frontier market corporate issuers (i.e. solar PV), but do not want to take currency risk exposure. Deeper derivatives markets allow splitting currency risks from credit risks and thus providing additional flexibility, risk management opportunities, and thus greater liquidity. While volumes are still relatively small, growth is significant. Today, TCX can offer pricing and hedging capacity in more than 70 emerging and frontier markets with no tenor restrictions. This means even long maturity bonds to support infrastructure or corporate growth can be hedged in and out of local currencies. To lay-off some of the currency resulting currency exposure, TCX and some of its international financial institution (IFI) shareholders have successfully developed local currency bond programme, which is mostly catering to the demand of off-shore investors such as specialized funds and family offices. Figure 3 shows exotic currency bonds issued by investment grade shareholders of TCX in the past 6 years. The appetite of investors in such off-shore local currency bonds seems to grow with eating.

### Removing barriers for trade finance in local currencies

Dollarization is deep-rooted and any changes will be of gradual nature. Moving from a dollar centred to a multipolar/bilateral local currency-based trade financing system will take time. Remaining obstacles for local currency financing will need to be better understood and reduced or eliminated. Incentives and policies will be needed to establish and maintain sufficiently deep and liquid funding or hedging market in local currencies. Much needs to be done, and the mentioned points below are by no means an exhaustive list, but rather serve to advance the policy discussions.

Among the technically straight-forward, but politically challenging steps would be a reform of the current OECD regime for export financing. A similar case can be made for the current OECD DAC system assessing Official Development Assistance eligibility of development finance loans. The OECD Arrangement seeks to prevent an export credit race in which exporters compete on the basis of which are granted the favourable financing terms by specifying minimum interest rates for official financing support. The OECD updates and publishes these Commercial Interest Reference Rates (CIRRs) on a monthly basis for a relatively narrow range of (hard) currencies such as Euro, Swiss franc or US dollar. While it is possible to have new official CIRR determined for other currencies, this has not happened.

Furthermore, the Arrangement allows export financing to be tied to firms of the financing country, if a minimum concessionality threshold of 50 per cent for “least developed countries” and 35 per cent for all other developing countries are reached. As CIRRs are required to assess the concessionality level, tied aid is typically delivered with low-interest hard-currency finance. To promote a more sustainable trade financing in local currencies, the OECD should consider adopting a broader market reflective approach to set CIRRs. Bloomberg and Reuters offer for many currencies swap curves which could be used to translate an SDR based CIRR into local currency CIRR. If no swap curves are available in markets, a specialized provider like TCX could provide long-term swap-curves to the OECD on a transparent and fair basis.

Innovation would also be required on the level of ECAs to promote financing in the currencies of importers. ECAs are reluctant to offer guarantees for local currency loans, because this could trigger a contingent local currency risk, which is difficult or expensive to hedge. However, based on the experience from other sectors, local currency financing (combined with more comprehensive hedging strategies) would most likely improve the repayment capacity of importers and should lower defaults and losses give defaults. Moreover, ECAs would face so called right-way risk currency exposure: a default and payment under a guarantee is more likely in a situation of macro-weakness and crisis, when the value of the guaranteed loan is also depressed, and vice versa. To get more comfortable with these new risk dynamics, the Berne Union and its members, may want to rigorously analyse their own data to quantify how much currency risk had contributed to claims and defaults. Armed with this evidence, a bigger effort to advocate and support local currency financing with guarantees on local currency loans should be contemplated.

### Conclusions

Today's heated debate about global trade and the SDG agenda provide the right background to question the reliance on a few hard-currencies to finance trade. Putting currency risk on the shoulders of borrowers in developing countries does not seem an effective, sustainable or fair solution. Markets with the support of specialized institutions can mobilize local currency financing in rapidly increasing volumes. Policy reforms on the OECD and ECA level are needed to put these new market forces to good use.

### Note

The author's opinions expressed in this chapter do not necessarily reflect the views of TCX or its shareholders.

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**Harald Hirschhofer** is Senior Advisor at TCX. A trained macro-economist, he joined TCX at its beginning in 2008 to implement a macro-fundamental based pricing approach for currency hedging in small frontier markets. Today, he works on scaling up the development impact of TCX and on new strategic initiatives. Over the past years, a large part of his efforts has been dedicated to developing local currency financing solutions for infrastructure investments in frontier and emerging markets. Prior to TCX, Harald worked at the IMF, the US Congress, and a London investment bank.