Policy conversations on the de-dollarization of Kenya’s foreign currency reserves

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Executive Summary
Trends by the emerging economies of China and Russia to reduce the use of the dollar and the SWIFT payment platform in their dealings are expected to have ramifications for developing economies like Kenya. The gradual political and economic undercurrents are influencing other countries to adopt strategies that shield them from adverse exposure to the US fiscal and monetary policies. The weaponization of the dollar system against countries operating divergent to US interests has forced them to pursue multilateral trading arrangements where they can use their local currencies or non-dollar currencies. In Kenya’s situation, there is a need to appreciate the significant cost of dollar-based trading in international trade. The country suffers significant exposure from foreign exchange loss and strained supply to the dollar which aggravates the depreciation of the Kenyan shilling. Likewise, policies by the US Federal Reserve to increase interest rates have accelerated dollar-denominated capital flight from developing economies to safe havens in the Global North. While policy analysts estimate that the dollar system will continue to dominate as the world’s reserve currency, de-dollarization partnerships and alternative trading systems are growing and threatening the dollar. An anticipated
fightback by the US against de-dollarization is expected due to the potential negative impacts on her economy, and geopolitical and economic leadership status in the global arena. Kenya and other developing economies should analyze and navigate the dynamic geopolitical and geo-commercial ecosystem to advance their development, economic, and national security interests. Policy interventions should shield the country from risks due to reliance on the dollar system while adapting to fluid global realities.

Context

Developing economies like Kenya are economically exposed to a rise in global multipolarity and the strengthening of the dollar. The power play between the United States, the conglomeration of Brazil, Russia, India, China, and South Africa (BRICS), and other nations continuously threaten the foundation underpinning global trade. The geo-commerce landscape is highly fluid to threats of escalating trade and currency tensions. For instance, the United States is accused of unilaterally using the world reserve currency status of the dollar and the international payment platform known as SWIFT (Society for Worldwide Interbank Financial Telecommunication) to reward or lockout enemies of the global financial system. The employ of US sanctions and denial of access to the dollar system has motivated the stifling of international investments and trade which are central to socio-economic development. Likewise, the strengthening of the dollar is proving hazardous to the global economy. Unfortunately, developing countries like Kenya continue to bear the heaviest burden. A strong dollar spurred by the increase in the interest rates in the US has resulted in massive capital outflow to safer and economically stronger havens in the global North. Coupled with extant debt distress, rising US interest rates have exacerbated inflationary pressures and currency devaluation in developing economies. The deteriorating strategic environment for which Kenya and her peers have limited fiscal and monetary tools for mitigation has resulted in de-dollarization conversations to occupy a policy
Key Issues
The paper explores historical and emerging issues around de-dollarization. These include the global trends behind de-dollarization, mitigation from dollar exposure and strategic policy consideration for Kenya.

Global trends behind de-dollarization
Since 1945, the dollar has enjoyed the prestigious status as the main intervention currency, hence the world reserve currency. For more than 60 years, this position has rarely been threatened due to the US’s strong and stable economy, robust financial systems, and dominant military. Oil and mineral markets have historically preferred to use the dollar making it the preeminent currency in commodity trading.

Recent trends illustrate that the dollar still plays an outsized role in international commerce despite the shrinking role of the US economy in global productivity. However, fissures are emerging with rising de-dollarization actions by numerous countries. De-dollarization is gradually gaining traction as economic entities reduce their reliance on the dollar in international markets, global debt, and commerce. Several central banks are holding
fewer dollars as part of the countries’ foreign currency reserves. Trends indicate that the dollar share of global reserves dropped from around 70% in 2002 to below 59% in quarter one (Q1) of 2021. Further analysis of the out-shifting of dollars shows a move in two directions. 25% of the shift was compensated with more reserves held in the Chinese renminbi (RMB) currency. The rest of the 75% is attributed to numerous smaller countries reducing their dollar reserves. This drop is expected to continue. More than 80% of 57 central banks surveyed by the World Gold Council expected to expand their gold reserves in the 2022-23 period. Most of the banks were from emerging markets and developing economies (EMDEs) are less confident of the continued domination of the dollar.

On the global stage, de-dollarization trends are fueled by opposition to the US superpower status. Geopolitical pressures for a reset to a multipolar system are growing. New and old powerhouses of China, Russia, and India question the dominant status of the United States and its allies. 2021 data indicates that BRICS contributes 31.5% of the global Gross Domestic Product (GDP) economic output compared to G7’s share of 30.7%. The G7 group comprises the United States, Canada, France, Germany, Italy, Japan, the United Kingdom, and European Union. With the projected expansion of BRICS, with Bangladesh, Egypt, the United Arab Emirates (UAE), and other countries joining the BRICS New Development Bank, the gap is widening. BRICS is projected to contribute over 50% of the global GDP by 2030. Equally, Mexico, the long-term partner to the US under the Canada-United States-Mexico Agreement (CUSMA) is poised to join BRICS. Analysts indicate these changes show the growing distrust in the US’s ability to trade on fair and equal terms.
Sovereign states are distressed about the US weaponization of the dollar as part of its economic sanction package. The application of sanctions is viewed as indiscriminate by allies and non-allies suffering alike. As a result, countries are actively encouraging trading partners to pursue alternatives to the dollar and its affiliated payment systems. For instance, five European nations established the Instrument in Support of Trade Exchanges (INSTEX) system to help support Iran’s humanitarian efforts thus bypassing US sanctions on Iran. In Asia, the Central Bank of India launched a rupee settlement mechanism for international trade. Five other ASEAN economies also established a regional integrated payment network for direct foreign exchange settlement bypassing the dollar. Similarly, Russia and China agreed on the usage of RMB for trade settlement between Russia and countries in Asia, Africa, and Latin America. These monetary options in addition to divestiture in alternate assets like gold are efforts by countries to wean off the reliance on the dollar. It is the view of these nations that the dollar is the last of the US superweapons. Through BRICS, China and Russia are lobbying other countries to follow suit and de-dollarize. Recently, the oil trade which is often considered the lynchpin of dollarization has made unprecedented efforts from pure dollar trading. Well-known US allies in the Middle East and Asia like India, Saudi Arabia, and the United Arab Emirates have entered into oil deals payable in non-dollar currencies with China and Russia.

While analysts expect the US dollar to continue with its reserve currency role in the foreseeable future, erosion threats cannot be wished away. Risk factors to dominance by the dollar and supportive systems are varied. They include the advent and popularity of electronic trading platforms which have enabled central banks to deal in currency outside the big four of the dollar, pound sterling, yen, and euro. This has allowed countries to increase trade in larger shares of non-dollar assets. The Ukraine conflict has made foreign cargo predominantly priced in dollars more expensive. Thus, many countries are shifting their currency holdings and investments in alternative assets like the RMB.
Mitigating dollar exposure

The world economy has been exposed to dollar pressure from two fronts; the US monetary policy and the strengthening of the dollar. The economies of developing countries have been impacted greatly by the effect of the US monetary policies initiated to mitigate the effects of the 2008 financial crisis. Recent happenings in 2023 around the protection of the US banking sector have borne similar impacts. The US Federal Reserve has been at the forefront of increasing interest rates to mitigate against ravaging inflation pressures. As a result, investments were pulled from developing and emerging markets to benefit from the high yield of dollar-denominated Treasury assets. Even policies by dollar-dominated institutions like the International Monetary Fund (IMF) had a similar effect on the Asian economies. The Asian financial crisis of 1997-1998 showed that a high level of dollars was required to insulate economies against monetary shocks. The pulling of dollar investments to safer jurisdictions leads to economic erosion that is harmful to national well-being.

Dependency on developing economies on the dollar system coupled with the weaponization of the world reserve currency has been detrimental. These countries experience a gradual erosion of diplomatic, political, strategic, and economic influence. The entrenchment of the dollar in the global economy has been staggering. It is estimated that two-thirds of all dollars in circulation are outside the US. The situation is necessitated by the fact that the dollar is used to price and undertake global trade and investment contracts. It is factual that petroleum and mineral commodity markets have exclusively been operated in dollars. Thus, despite the economic sway of oil-producing nations, they are continually...
vulnerable to dollar weaponization. The locking out of Iran and other oil producers has had a devastating effect on the individual and global economies. Freezing of roughly $300 billion of Russia’s assets on the advent of the Ukraine conflict and the lockout of Russian oil from the SWIFT system has been contributing factors to the buildup of global inflationary pressures. It resulted in the recalibration of the energy market even among allies of the US. Resultantly, the European Union, the US itself, and the Global North were exposed to energy insecurities. Other nations that have experienced the brunt of the weaponization of the greenback comprise Afghanistan, Venezuela, and North Korea. China has equally been threatened with a SWIFT lockout if it fails to follow United Nations sanctions on North Korea.

As a result of the negative effects of exposure to the dollar and US monetary policies, nations, and business entities are accommodative to de-dollarization interventions. The overarching reason is the need to immunize their foreign and trading policies from dollar dependency. Sanctioned countries like Iran and Russia have rolled out non-dollar-based payment alternatives. The ultimate aim is to diversify national holdings from the greenback and guard against the US economic bullying.

Since the turn of 2023, de-dollarization efforts have been widely reported. China and Brazil agreed to trade in their currencies thus removing the US dollar as an intermediary currency. China and France completed their first liquefied natural gas (LNG) trade deal using the RMB. Equally, Malaysia, Indonesia, Singapore, and Thailand developed a digital payment system supporting trade settlements in local currencies. US ally Saudi Arabia secured Yuan-based loans under the Belt and Road Initiative (BRI) framework to build infrastructure projects. African countries like Zimbabwe and Ghana have adopted the RMB as part of their official trading and reserve currencies. Nigeria plans to shift more of its reserves into the RMB from the dollar. In South Africa, Zambia, and
Mauritius, a growing demand for the RMB has been reported. Due to China's role in global trade, direct trading using the RMB is attractive as it has the potential of reducing trading costs. This option is appealing to the continent as the Sino-Africa trade stood at $254.3 billion as of 2022. Developing controlees should consider policy options that guard against dollar exposures from weaponization and deterrent US monetary policies.

The Central Bank of Kenya (CBK) is charged with managing the country’s foreign exchange reserves. However, the country's forex stockpile has been eroded as a result of lower foreign funding, faster growth of imports than exports, and a slowdown in remittances from Kenyans abroad. Coupled with increased demand for the dollar, the country's reserves fell short of the standard 4.5 months of import cover. The situation is similar to other East African economies that are grappling with the dollar shortage. As of March 2023, Kenya had import cover for 3.7 months. During the same time, Tanzania’s cover was at 4.3 months, Uganda’s was at 3.6 months and Rwanda's stood at 4.5 months.

The highlighted risks emanating from a dollar dominance of the country’s reserves are deemed highly unlikely to be short-term. Alternative policy approaches need consideration, especially considering that a significant number of Kenya's trading partners are inclined to BRICS direction of the de-dollarization of their trade and reserves. These include China, Saudi Arabia, India, and South Africa. There are evident risks that Kenya may be nudged towards making payments in non-dollar currencies. Without proactive policy considerations, the country may continue to be exposed to dollar liquidity challenges that may affect operations of the capital market, commerce, and currency.

Forex policy options for Kenya

The Central Bank of Kenya (CBK) is charged with managing the country’s foreign exchange reserves. However, the country's forex stockpile has been eroded as a result of lower foreign funding, faster growth of imports than exports, and a slowdown in remittances from Kenyans abroad. Coupled with increased demand for the dollar, the country's reserves fell short of the standard 4.5 months of import cover. The situation is similar to other East African economies that are grappling with the dollar shortage. As of March 2023, Kenya had import cover for 3.7 months. During the same time, Tanzania’s cover was at 4.3 months, Uganda’s was at 3.6 months and Rwanda's stood at 4.5 months.

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Conclusion

Financial experts anticipate that the dollar’s dominance in global commerce and economy will be exposed to de-dollarization threats as the world moves towards multipolarity. Resultantly, de-dollarization activities will grow among states and multinational companies. Growing economic clout and advocacy by BRICS nations and their affiliates against the G7 is expected to reset power dynamics of traditional global bodies like the United Nation and its peers. These changes would affect the current dollar-dominated financial systems that underpin international trading. Ambivalence, partisan geopolitics, and coalescing against the West pose both national and economic risks and opportunities to developing countries like Kenya. Policymakers should constantly survey the resulting shifts in economic statecraft and how they will impact Kenya’s socioeconomic well-being. Policy interventions should allow Kenya to tactfully navigate the geopolitical and geo-commerce minefields around de-dollarization to safeguard and advance her development, national security, and economic interests.
Recommendations

1. The National Treasury and the Central Bank of Kenya should explore the development of policy frameworks on de-dollarization to safeguard Kenya's reserves and assets in line with trading and national security realities.