

The GLOCEPS

Weekly Influential Brief

Research and Analysis in Development Pillar

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

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Photo Credit: Cryptopolitan

President William Ruto urges the de-dollarization of intra-African trade

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





conversation for the Global South. Equally, geopolitics and geo-commerce campaigns by BRICS to challenge the dollar hegemony force developing countries to explore opportunities and threats from de-dollarization. With BRICS economic productivity documented to have overtaken that of the G7, coupled with the deployment of alternatives to the SWIFT system,

their influence on their trading partners to influence transitions to non-dollar payments cannot be ignored. Policy discourses are imperative in adaptation to the emerging de-dollarization reality including divesture of foreign currency reserves in line with trading and national security considerations.

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.



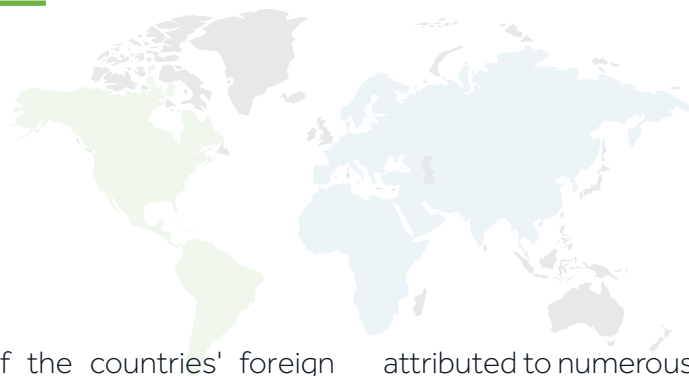
Photo Credit: The Express Tribune

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.

Figure 1: Currency Composition of Global Foreign Exchange Reserves 1999-2021 (as percent)

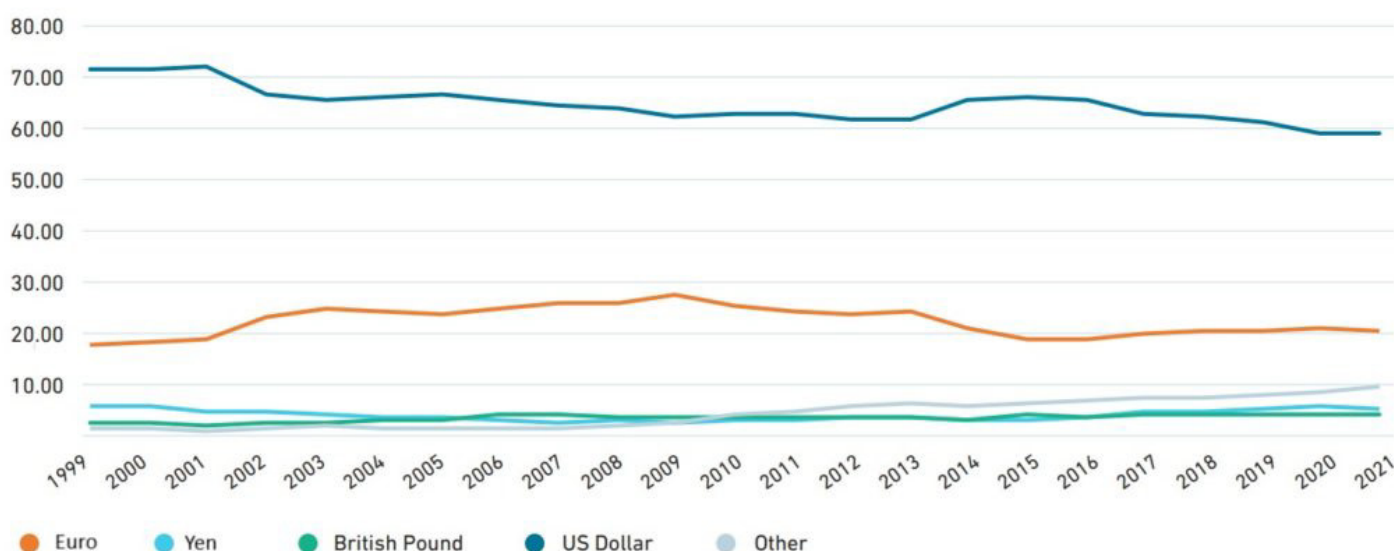


Photo Credit: warontherocks.com

Sources: IMF Currency Composition of Official Foreign Exchanges Reserve (COFER).

Note: The "other" category contains the Australia dollar, the Canadian dollar, the Chinese renminbi, the Swiss franc and other currencies not separately identified in the COFER survey. China became a COFER reporter between 2015 and 2018.

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 divesture 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.

Proposed BRICS Expansion

- Current BRICS members
- Proposed BRICS members

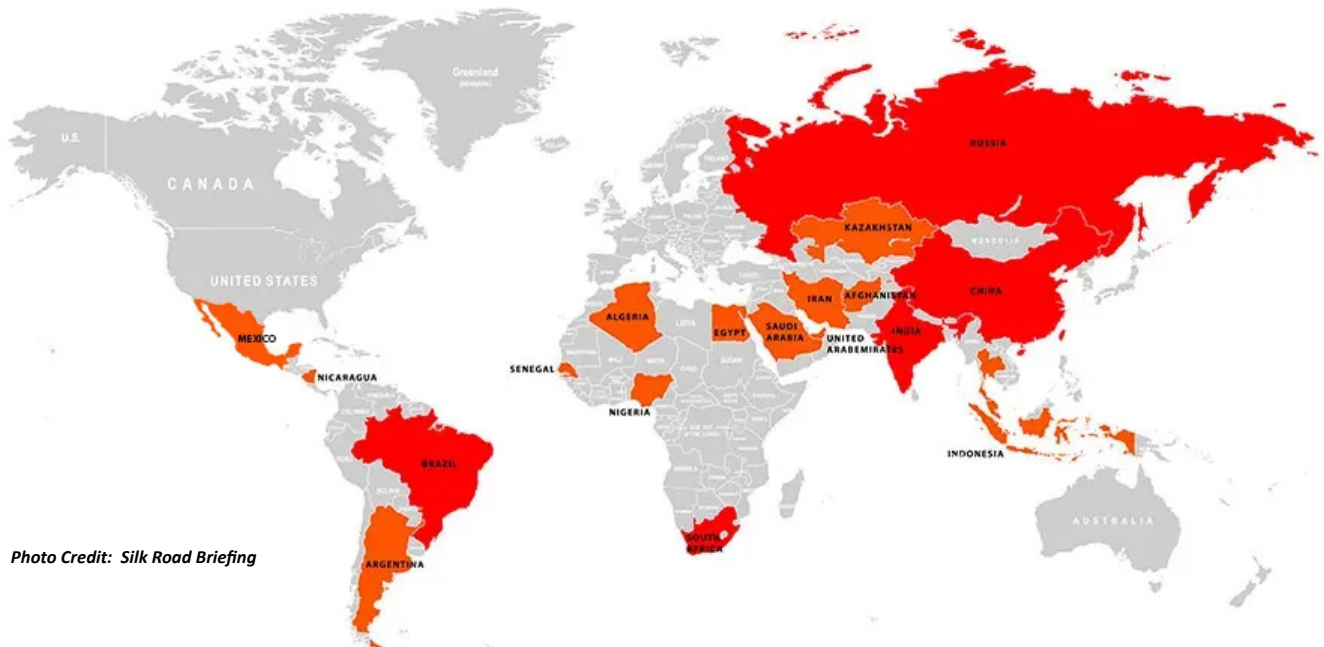


Photo Credit: Silk Road Briefing

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

The US dollar has dominated global trade and capital flows over many decades. However, many nations are looking for alternatives to the greenback to reduce their dependence on the United States.

1920s

The dollar begins to displace the pound sterling as an international reserve currency after World War I. The United States is a significant recipient of wartime gold inflows.

1944

International trade is conducted using the US dollar under the Bretton Woods Agreement.

1960s

European and Japanese exports become more competitive with US exports. There is a large supply of dollars around the world, making it difficult to back dollars with gold.

1971

President Nixon ceases the direct convertibility of the US dollar to gold.

2014

Following the annexation of Crimea, Russia prioritises dedollarisation in response to Western sanctions.

2007-2008

Global financial crisis: Investors seek US dollars expecting the currency to retain its value.

1981

After years of hyperinflation, the US dollar loses two-thirds of its purchasing power.

2022

Central banks buy gold at the fastest pace since 1967 as countries diversify their reserves away from the dollar. The war in Ukraine results in Western sanctions against Russia. As a result, Russia and China deepen cooperation between their financial systems, with ruble-yuan trade increasing 80 times in eight months.

2023

WORLD FOREIGN EXCHANGE RESERVES

Swiss Franc	0.2%
Australian Dollar	1.9%
Canadian Dollar	2.5%
Yuan	2.8%
Pound	4.6%
Yen	5.3%
Others	3.3%
US Dollar	59.8%
Euro	19.7%

Despite these movements, few expect to see the end of the dollar's global sovereign status anytime soon. Currently, central banks still hold about 60% of their foreign exchange reserves in dollars.

VOLUME OF CHINESE-RUSSIAN TRADE IN YUAN (bil)

< Invasion begins

- Brazil and Argentina discuss the creation of a common currency.
- The UAE and India explore the use of rupees to trade non-oil commodities.
- Russia and Iran are working together to launch a cryptocurrency backed by gold.

The Star graphics

Sources: Visual Capitalist, Currency Composition of Official Foreign Exchange Reserve, Reuters, Vedmosti, Atlantic Council, Congressional Research Service, IMF, Kitco, G1, Business Insider, Yahoo and Wikipedia





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

WORLD FOREIGN EXCHANGE RESERVES

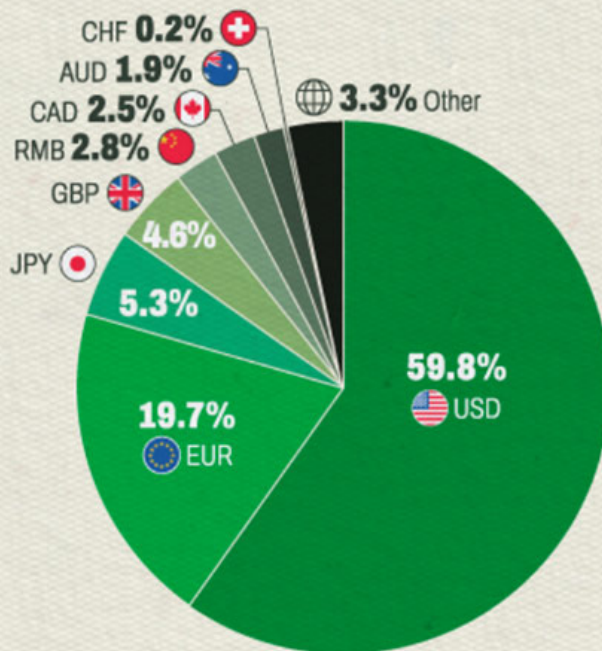
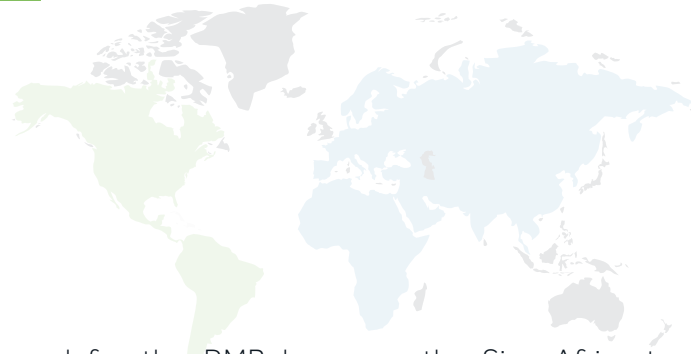


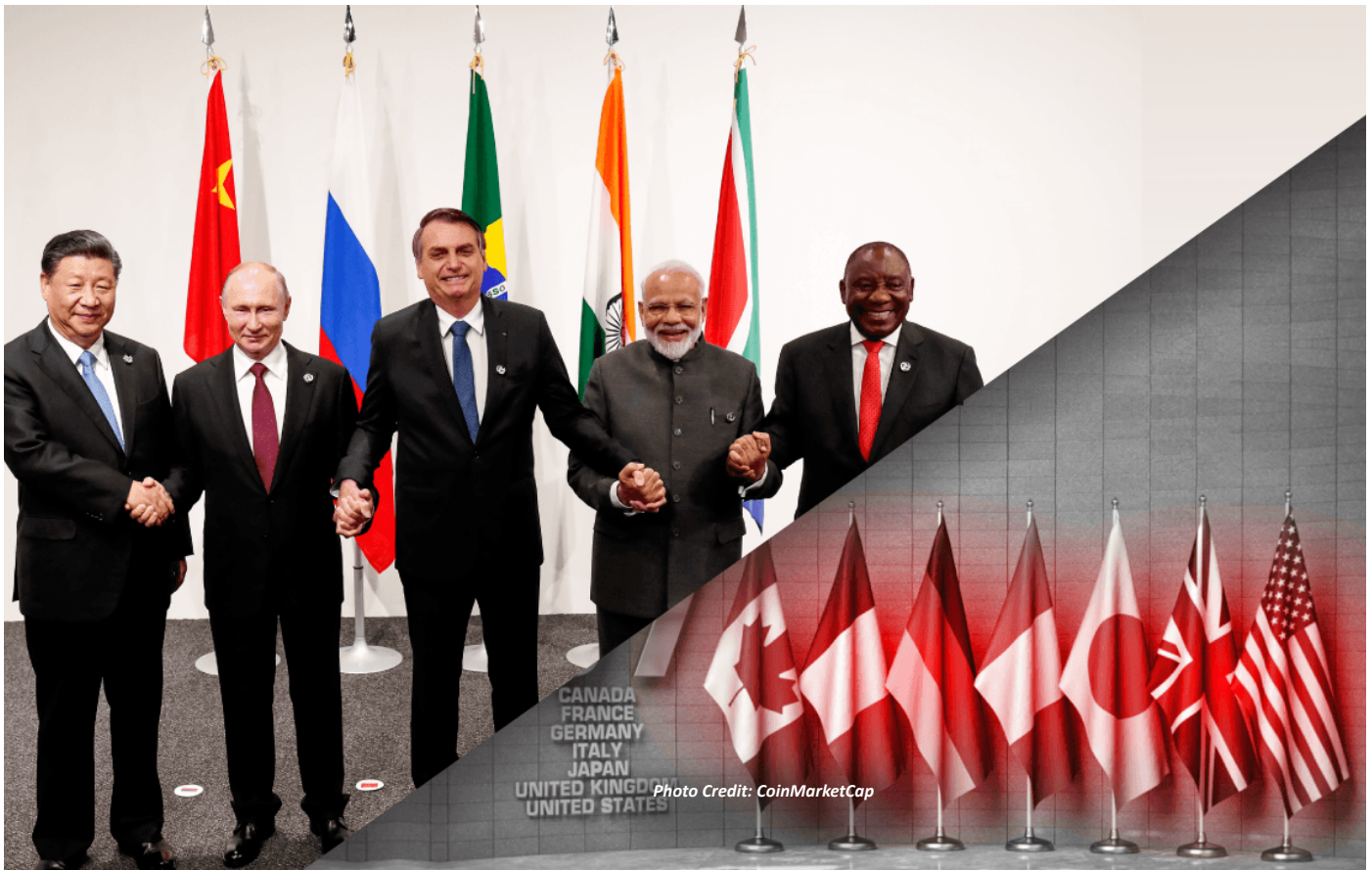
Photo Credit: Ahead of the Herd





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.



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.

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





conversion that underpin international trade.

To mitigate against these impacts, Kenya should consider diversifying trade and later foreign currency reserves away from the dollar while the CBK employs interest rates and monetary policies to stabilize and stimulate economic growth. Countries like Egypt are reducing international borrowing by diversifying from dollar to RMB-denominated debt.

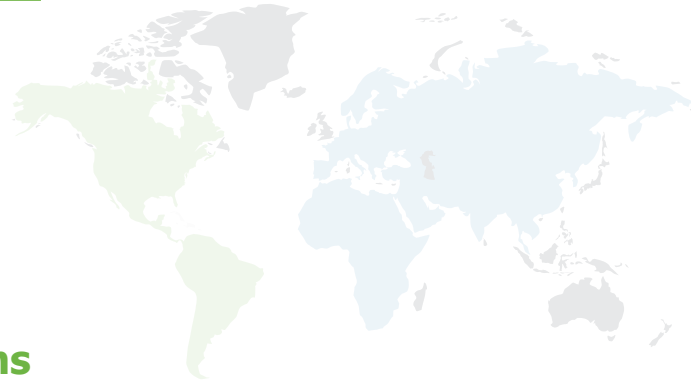
There is a growing appreciation for the use of national security considerations in pursuing and approving international investments, mergers, and acquisitions. Moreover, the pursuit of local industrial, agricultural, and service productivity would enhance self-sufficiency and reduce dollar demand for imports. Policies for maintaining fiscal stability, enhancing a diversified reserve base, and reducing budget deficits should form part of Kenya's fiscal and development strategy.



Conclusion

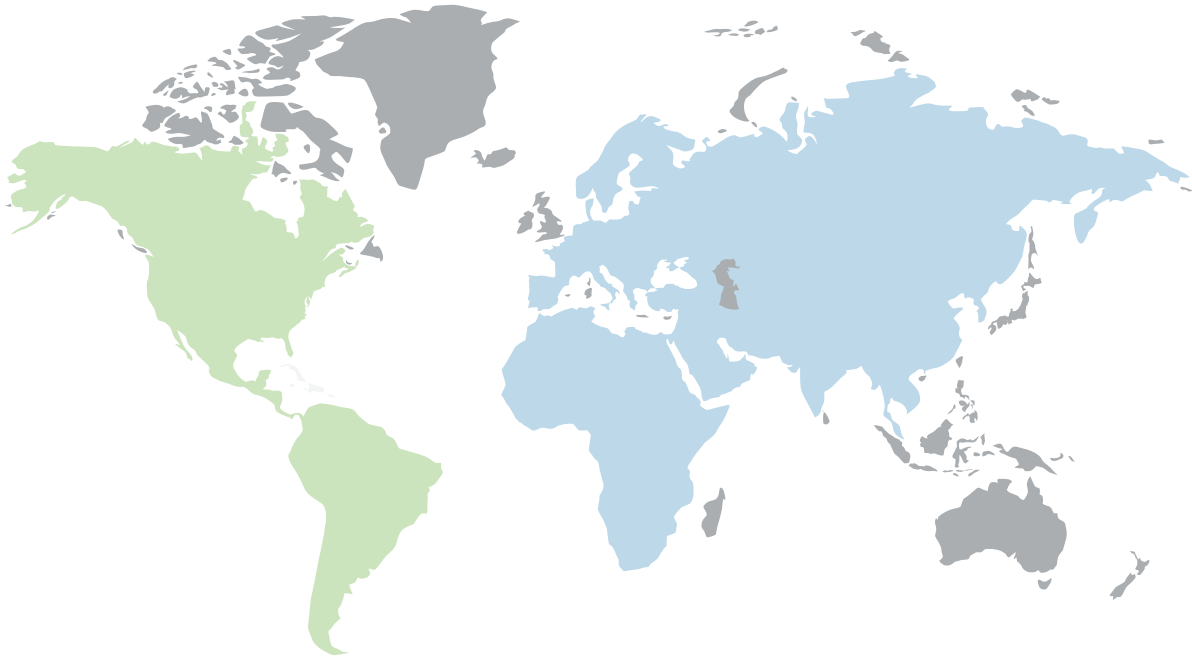
Financial experts anticipate that the dollar's dominance in global commerce and economy will be exposed to de-dollarization threats as the world moves towards multipolarity. Resultantly, de-dollarization activities will grow among states and multinational companies. Growing economic clout and advocacy 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.



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