# Why time is ripe for the WPU

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The advantages of diversifying the currency denomination of international borrowing have been known for decades. In particular, using a basket comprising the dollar and other major currencies would mean borrowing costs would be less volatile than borrowing exclusively in dollars. The difficulty has always been designing practical arrangements that would implement a long-desired objective in a way which works for both borrowers and lenders.

But the issue had hardly seemed very pressing in recent years because dollar lending was cheap and abundant. This has now changed. The Federal Reserve has led a tightening in global monetary policies that is the sharpest for many decades. The combination of higher policy rates and the Fed reducing size of its balance sheet has shifted the whole dollar yield curve upwards.

By the end of 2022, global liquidity had begun to fall for the first time since the global financial crisis, and decline that has almost certainly deepened since then: see Figure 1. Global liquidity simply means international credit in a foreign currency (that is, bank loans and bond issuance) – dollars to borrowers outside the United States, euros to borrowers outside the euro area and so on. This is the measure the BIS, at the behest of the G20, now publishes every quarter. This is a fall in nominal terms -- allowing for inflation, the fall in real terms is steeper.

About three-quarters of the BIS measure of global liquidity is dollar borrowing by entities outside the United States. Most of the rest is euro borrowing by those outside the euro area. One little-observed fact is that the growth in euro-denominated international lending growth in recent years has held up while that in the dollar has declined.

Figure 2 shows that between 2009 and 2013, there was no increase at all in euro-denominated credit to borrowers outside the euro area. Only dollar-denominated liquidity rose strongly. Then there was a striking reversal. By 2016, € liquidity began to outpace that of the dollar. Over this period, the contribution of euro-denominated liquidity at the margin exceeded the average three-to-one split with the dollar. Hence the euro added a valuable currency diversification buffer to international finance.

This reversal of roles largely reflects monetary policy divergence between the Fed and the ECB. It also reflects different economic and financial circumstances. Given the increasing weight of bond markets – rather than bank loans -- in international lending, it is differences in long-term interest rates which are key. Changes in long-term interest rates tell us about both future expected future short-term interest rates and about the influence of central bank balance sheet policies and inflation/growth risks on term premia.[2] Figure 3

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[2] On this, see Marina Misev and Philip Turner: "Is a bond market crisis imminent?" *Central Banking Journal* vol XXXII. Pp 52-57. June 2022.

compares the yield on US Treasuries with that on the French bond. Since 2014, euro yields have fallen well below dollar yields. Note also that the year-by-year changes are not closely correlated.

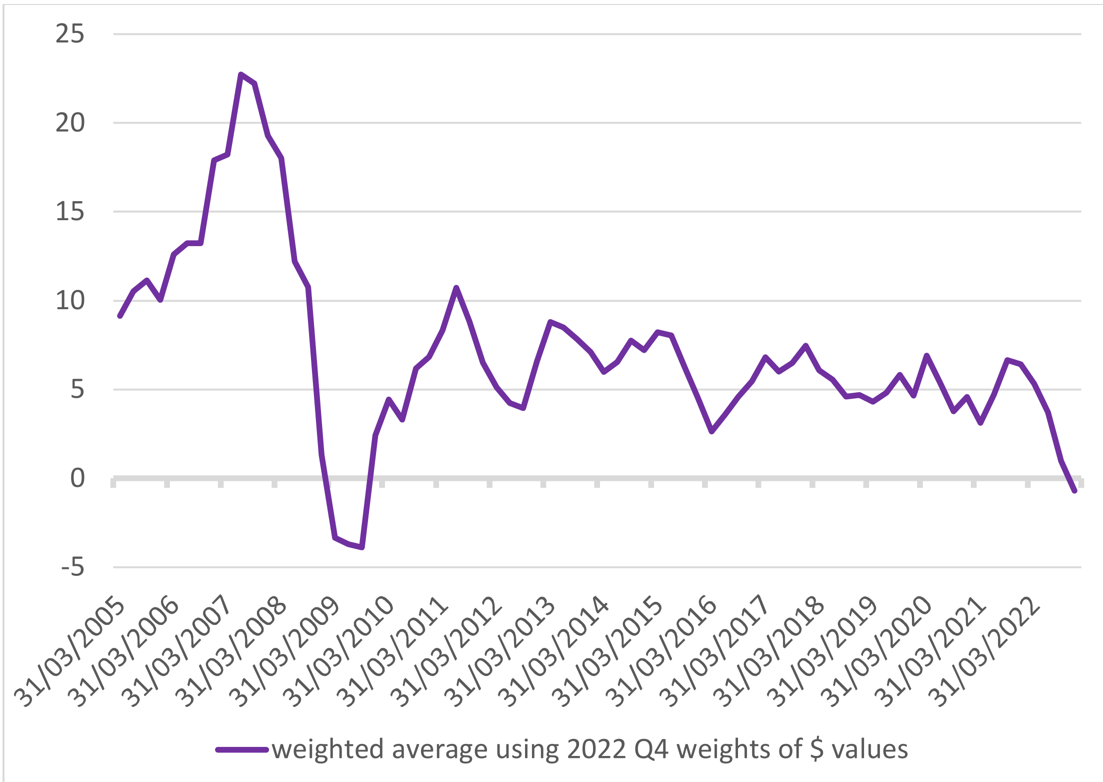
A currency basket would offer even larger currency diversification benefits – because it would include other currencies.  Asia now needs to finance increased investment in pursuit of its green transition. Relying only on dollar finance for all its external borrowing would make its future borrowing costs more volatile, and perhaps even more costly, than ensuring that some proportion of its borrowing in the WPU basket of currencies.

Remember the starting points of borrowers and lenders. The offshore dollar debt of many countries is already very high so that making sure new debt has a substantial non-dollar component would help to moderate their dollar exposures. The same principle applies on the lending side. Adding currency-basket-based bonds would add diversification to international bond portfolios that at present contain none. From the points of view of both borrowers and lenders, therefore, the time is ripe for WPU bond issuance.

## Figures

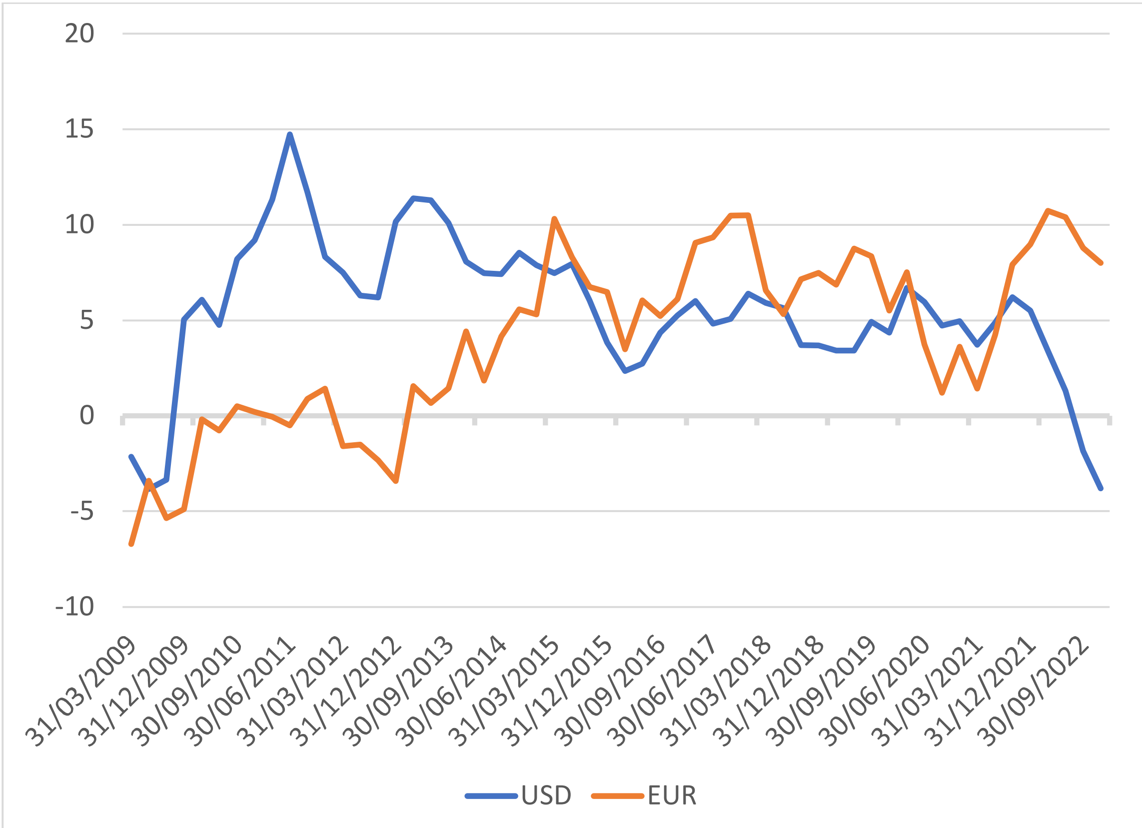
**Figure 1 – Global Liquidity**

Year-on-year percentage changes in $ and € credit to non-bank non-residents.



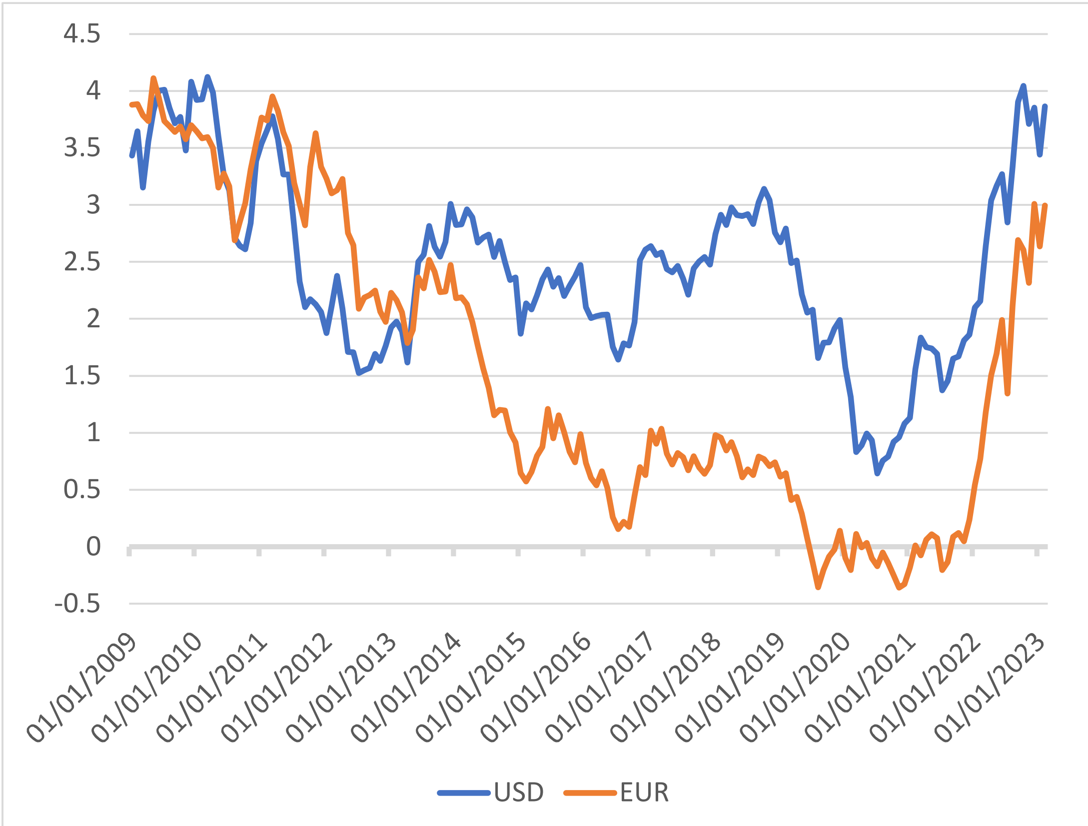

Source: BIS Statistics Explorer

**Figure 2 - $ and € credit expansion to borrowers outside respective currency areas***




*Bank loans plus debt securities, annual percentage changes.
Source: BIS Global Liquidity Indicators

**Figure 3 - US Treasuries and the French bond**
10-year yields in $ and € bond markets




Source: Hördahl et al. (2016), updated