

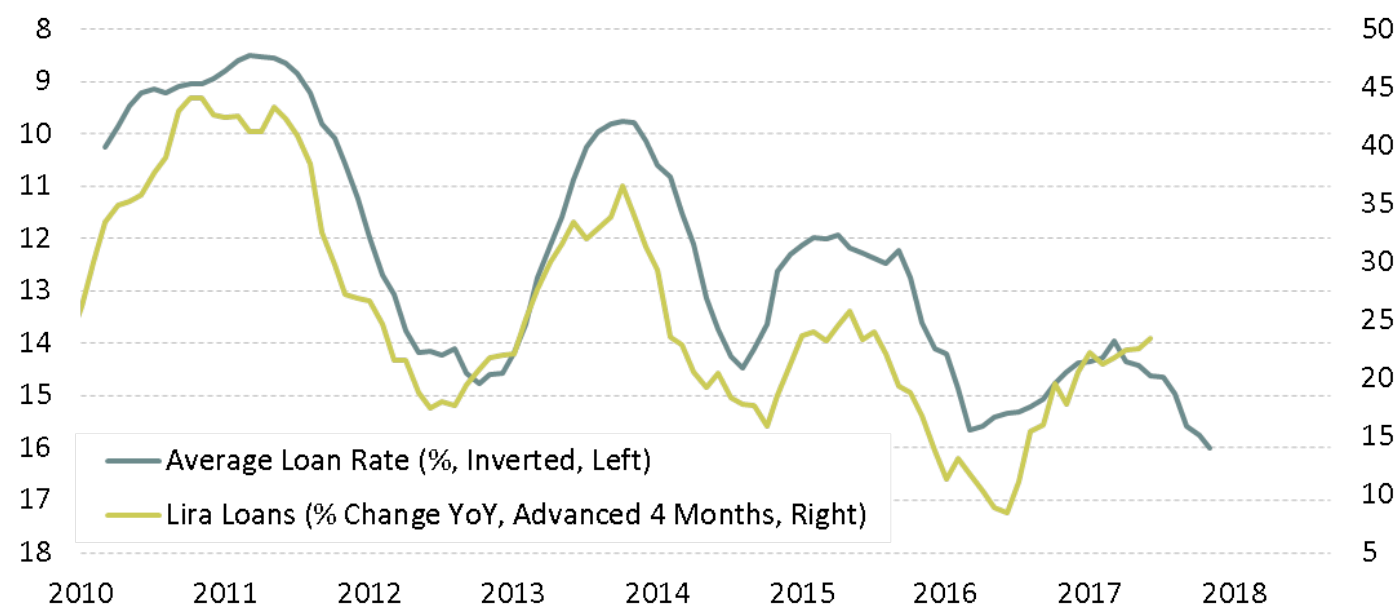
One Central Bank, Two Currencies, Three Problems

As global fixed income investors, we spend a lot of time thinking about central banks. Most countries in which we invest have some sort of inflation-targeting regime where the central bank adjusts short-term rates in order to impact macroeconomic variables. The country’s currency also plays a role as an economic regulator. But what happens when instead of one currency, the country’s citizens toggle between two currencies when making economic decisions? Let us use Peru and Turkey to highlight three extra challenges that arise when assessing investment opportunities in dollarized economies. ¹

On the credit side, it becomes harder for central banks to control growth by modifying the price of money. One way central banks try to influence the business cycle is by raising short-term interest rates which should in turn affect credit demand. As interest rates rise, consumer loans become less affordable and the hurdle rate that businesses apply to investment decisions increases. As a result, demand for loans slows. But what if local interest rates rise while foreign currency (FX) loan² rates stay low? The relationship between lira credit and interest rates has held fairly steady in Turkey over the last five years (see [Chart 1](#)). However, FX loan growth has been more volatile, driven largely by the much cheaper cost of funding in FX loans. Meanwhile, in Peru where the policy rate spread over dollar rates has been much narrower in recent years (see [Chart 2](#)), the price incentive to take out FX loans has been less pronounced.

Chart 1: Lira-Denominated Credit Growth Relative to Loan Rates

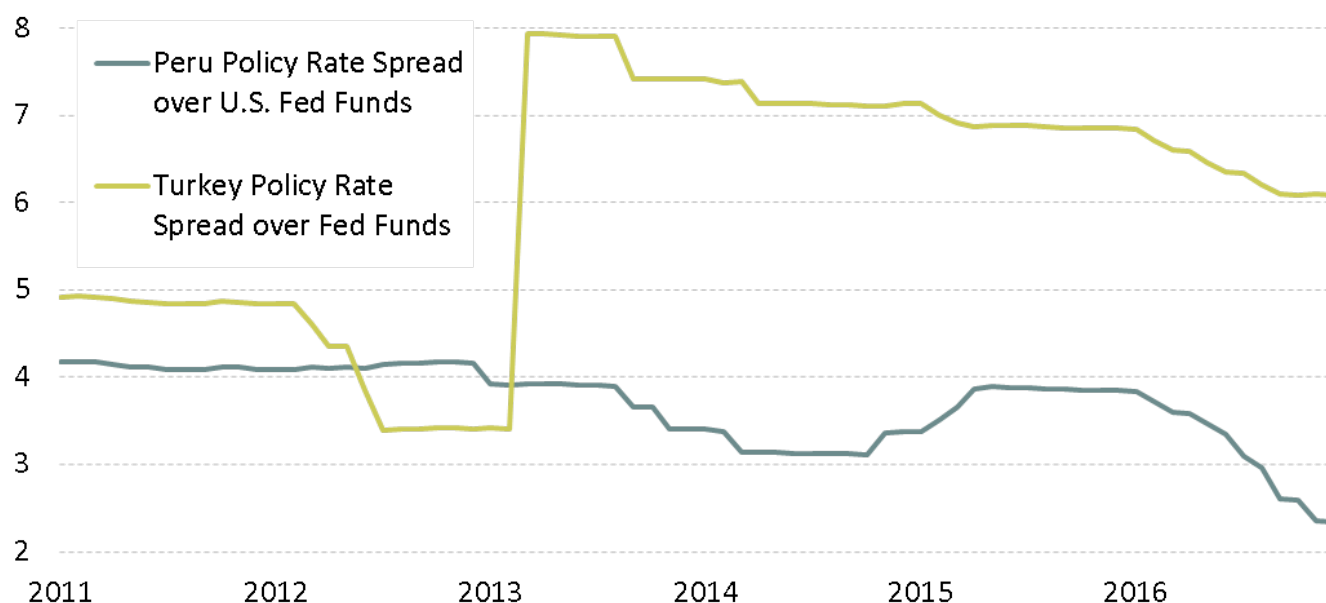
As of 9/30/2017



Source: Haver Analytics

Chart 2: Policy Rate Spreads over U.S. Federal Funds Rate

Percent, As of 10/31/2017



Source: Haver Analytics

On the deposit side, currency switches amplify financial market moves. Dollarized banking systems typically allow retail customers to switch quickly between local currency and FX accounts. Sometimes a shift in local deposits may result from a confidence shock, such as the coup attempt in Turkey in 2016. But often, locals tend to get worried when they see local currency weakness and chase the move by switching to FX deposits. This practice likely exacerbated the price move in USD/TRY in late 2016. Luckily, the impact works both ways. Confidence-boosting measures can beget USD selling, or locals could buy back their domestic currency and lean into rallies for exogenous reasons. For instance, despite the recent rash of negative headlines, Turkish households have actually reduced their FX deposits by USD \$6.6 billion in the last five weeks. In Peru, the steady appreciation of the sol from 2003-2013 encouraged a significant amount of USD sales.

Asset-liability mismatches also require extra monitoring in dollarized economies. If a local Turkish corporate had borrowed USD from a local bank in 2014, the lira principal would have nearly doubled by now. If this corporate mainly conducted its business in the domestic consumer market and collected lira revenues, solvency concerns would be quite high. This mismatch has been a known weakness of dollarized economies for years. As a result, macroprudential regulation has restricted FX loans to businesses with FX revenues, such as exporters or those who sell USD-priced commodities like oil. In both Peru and Turkey, very few consumers actually qualify for FX loans. As an additional safety measure, the Peruvian central bank has accumulated reserves to the tune of 32% of gross domestic product (GDP) as protection against adverse currency moves that might otherwise threaten financial stability.

Dollarized economies present incremental challenges to fixed income investors, but can also exhibit more significant price and information anomalies than the average country. If one acknowledges the extra level of instability and adds the required risk premia, investments in dollarized economies can be very attractive from a risk-adjusted perspective.

¹For context, in both banking systems for Peru and Turkey, dollar deposits account for roughly 40-50% of total deposits.

²FX typically means U.S. dollars, but could also include other reserve currencies such as euros, sterling, swiss francs, or yen.

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