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Challenges in Expanding Domestic-Currency Trade Agreements

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Abstract: *The increasing volatility of global financial systems and the dominance of major reserve currencies—especially the U.S. dollar—have prompted countries to explore domestic-currency trade agreements (DCTAs). These agreements aim to reduce dependency on foreign currencies, lower transaction costs, and enhance monetary sovereignty. However, despite growing interest, the expansion of domestic-currency trade faces multiple structural, institutional, and economic challenges. This paper analyzes key obstacles such as exchange rate volatility, limited financial infrastructure, asymmetry in economic development, institutional weaknesses, and global currency hierarchies. It concludes with policy recommendations to improve the viability of domestic-currency trade systems.*

Keywords: *DCTAs*

I. INTRODUCTION

International trade has historically relied on dominant global currencies, particularly the U.S. dollar. However, recent geopolitical tensions and financial risks have encouraged nations to pursue trade agreements settled in domestic currencies. These arrangements are especially relevant among emerging economies seeking to reduce exposure to external shocks and currency fluctuations.

Domestic-currency trade agreements (DCTAs) refer to bilateral or multilateral arrangements where trade transactions are settled using local currencies instead of a third-party reserve currency.

II. THEORETICAL BACKGROUND

2.1 Currency Dominance and Global Trade

The global financial system remains heavily dependent on reserve currencies. This creates structural barriers to adopting domestic currencies in trade due to liquidity and trust issues.

The persistence of dominant currencies reflects systemic dynamics similar to the Triffin dilemma, where reserve currency providers must maintain global liquidity, reinforcing their central role in trade.

2.2 Trade Agreements and Exchange Rate Dynamics

Trade agreements can reduce exchange rate risk and increase trade volumes. Evidence suggests that trade agreements can boost trade by up to 50% over time while reducing systematic exchange rate risk.

However, shifting to domestic currencies introduces new risks, particularly in economies with unstable or less liquid currencies.

III. KEY CHALLENGES IN EXPANDING DOMESTIC-CURRENCY TRADE AGREEMENTS

3.1 Exchange Rate Volatility

- One of the most critical challenges is the instability of domestic currencies.
- Volatility increases uncertainty in pricing and contracts.
- It negatively affects export competitiveness and trade planning.

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- Developing economies often lack hedging mechanisms.

Studies show that exchange rate volatility significantly affects trade flows, especially in economies with weak financial systems.

3.2 Lack of Financial Market Depth

Domestic currencies often suffer from:

- Low liquidity in foreign exchange markets
- Limited convertibility
- Underdeveloped financial instruments

When currency usage is low, it can actually hinder trade integration rather than promote it, indicating a threshold effect where insufficient adoption becomes counterproductive.

3.3 Infrastructure and Payment System Constraints

Efficient domestic-currency trade requires robust:

- Cross-border payment systems
- Banking networks
- Settlement platforms

In many regions, inadequate infrastructure and bureaucratic inefficiencies increase transaction costs and delays, limiting the effectiveness of such agreements.

3.4 Institutional and Governance Issues

Weak institutions create major barriers:

- Regulatory inconsistencies
- Lack of policy coordination
- Political instability

Institutional quality directly affects currency credibility and trade performance, making it harder to sustain domestic-currency agreements.

3.5 Asymmetry Among Partner Economies

Domestic-currency trade is harder to implement when:

- Economies differ significantly in size and stability
- Inflation rates diverge
- Trade imbalances persist

Such asymmetries create unequal benefits and risks, discouraging participation.

3.6 Persistence of Dollar Dominance

Despite de-dollarization efforts, the U.S. dollar continues to dominate:

- Trade invoicing
- Foreign reserves
- International payments

Efforts by blocs like BRICS to reduce dollar reliance have faced slow progress due to coordination and scalability challenges.

3.7 Transaction Costs and Currency Risk

Using domestic currencies can:

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- Increase transaction costs due to limited liquidity
- Introduce additional conversion steps
- Raise risk premiums

These factors discourage businesses from adopting local currencies for trade.

3.8 Technological and Digital Currency Barriers

Although digital currencies and CBDCs offer potential solutions, they face:

- Regulatory uncertainty
- Interoperability challenges
- Limited adoption

Significant uncertainties still hinder their effectiveness in cross-border trade systems.

IV. CASE INSIGHTS FROM EMERGING ECONOMIES

- African economies face infrastructure deficits and currency fragmentation.
- Asian economies experience currency volatility affecting trade strategies.
- Regional agreements often struggle with implementation gaps and governance issues.

These examples highlight that domestic-currency trade requires more than policy agreements—it demands systemic transformation.

V. POLICY RECOMMENDATIONS

5.1 Strengthening Financial Infrastructure

- Develop cross-border payment systems
- Improve currency convertibility
- Enhance banking integration

5.2 Enhancing Currency Stability

- Maintain macroeconomic discipline
- Control inflation
- Build foreign exchange reserves

5.3 Promoting Regional Cooperation

- Establish currency swap agreements
- Create regional clearing mechanisms
- Standardize regulations

5.4 Leveraging Digital Innovations

- Develop interoperable CBDCs
- Use blockchain for settlement efficiency

5.5 Institutional Reforms

- Strengthen governance
- Improve policy coordination
- Increase transparency

VI. CONCLUSION

Domestic-currency trade agreements present a promising alternative to traditional dollar-based systems, particularly for emerging economies seeking financial independence. However, their expansion is constrained by structural challenges including exchange rate volatility, weak financial systems, institutional limitations, and persistent global currency

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hierarchies. Addressing these challenges requires coordinated policy efforts, technological innovation, and long-term institutional reforms. Without these, domestic-currency trade will remain limited in scope and impact.

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