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Financial channel implications of a weaker dollar for emerging market economies

Key takeaways

- *The depreciation of the US dollar in 2025 has occurred against the backdrop of continued resilience of trade and economic activity in emerging market economies (EMEs).*
- *A depreciating dollar affects both borrowers' and foreign investors' balance sheets and tends to loosen financial conditions in EMEs through the risk-taking channel of exchange rates.*
- *As EMEs have increasingly become net creditors to the rest of the world, the currency hedging behaviour of EME investors has played a greater role in currency market dynamics in 2025.*

In 2025, the depreciation of the US dollar against the backdrop of monetary easing in the United States has stimulated a rally in emerging market assets. After reaching a multi-decade high in January 2025, the US dollar depreciated against a basket of emerging market currencies by around 5% through September before stabilising (Graph 1.A). As well as their impact on financial markets, easing financial conditions may have been a contributing factor to the surprising resilience of economic activity in emerging market economies (EMEs) in the face of higher tariffs and trade-related uncertainty (Amaral et al (2025); Maechler (2025)).

A depreciating US dollar acts as a tailwind for EMEs through several channels. Most directly, EME borrowers with dollar debts and domestic currency assets experience a windfall that strengthens their balance sheets and improves their creditworthiness, thereby supporting their demand for credit.

Balance sheet effects due to a weaker dollar also have repercussions for the *supply* of credit. For a global bank that has a diversified portfolio of loans, improvements in the creditworthiness of borrowers reduce the bank's credit tail risk, which allows it to expand its supply of dollar credit. This impact on the supply of credit is known as the *financial channel of the exchange rate* (Bruno and Shin (2015)).

Because dollar credit is important in financing working capital for supply chains, the financial channel of the exchange rate implies that a weaker dollar coincides with strong growth in goods trade (Bruno and Shin (2023)). This is especially the case for trade in manufactured goods, which often involves complex global value chains (GVCs) (Graph 1.B). The impact of the financial channel on trade helps to explain the recent resilience of trade. Despite higher tariffs and trade tensions, trade in goods that are part of GVCs, such as intermediate and capital goods, has held up better than that in other goods so far in 2025 (Graph 1.C).

Events in April 2025 highlighted a less familiar channel, which can act as a headwind for those EMEs that have expanded their foreign portfolio holdings. Investors in some EMEs have accumulated large holdings of US-dollar-denominated assets. Dollar depreciation, therefore, can impose losses on EME investors and set in motion adjustments that tighten domestic financial conditions. Events in April illustrated how the adjustment of foreign exchange (FX) hedge ratios by such investors can amplify currency moves (Shin et al (2025)). The importance of this channel is likely to increase over time among those EMEs that are moving towards becoming net creditors in international capital markets.

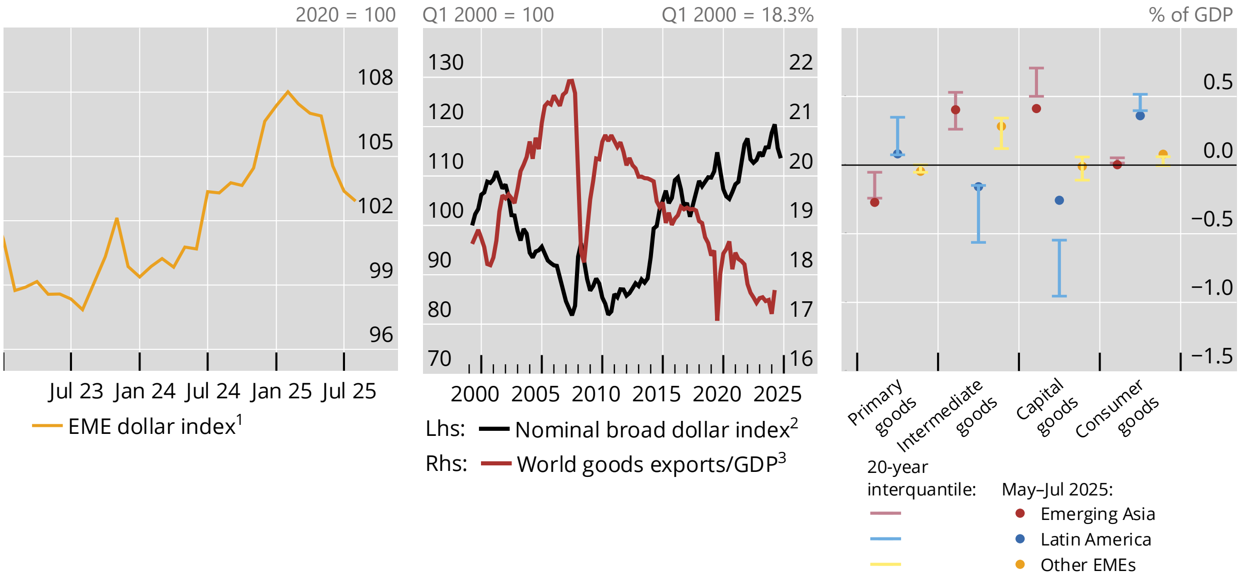
This Bulletin examines the impact of a weaker dollar on EMEs. It first explores the impact on EME borrowers with dollar debts and foreign investors holding EME currency assets. It then highlights the channel related to EME investors' dollar assets, which is likely to become more important in the future. This channel tends to introduce a countervailing headwind for EMEs from a weaker dollar.

Dollar depreciation tends to provide a tailwind for many EMEs — Graph 1

A. The US dollar has depreciated after peaking in early 2025

B. Global goods trade is strong when the dollar is weak

C. Trade between EMEs and the US has held up surprisingly well despite trade conflicts[4]



[1] US Federal Reserve's Nominal Emerging Market Economies US Dollar Index, which tracks the value of the US dollar against a trade-weighted basket of currencies from major EMEs. An increase indicates appreciation of the US dollar. [2] US Federal Reserve Board trade-weighted nominal dollar index for a broad group of US trading partners. An increase indicates appreciation of the US dollar. [3] Ratio of world goods exports to world GDP, both at constant prices. Index is set to the ratio in nominal terms in Q1 2000 (18.3%). [4] Trade balance of goods to the United States as a percentage of GDP, categorised by type of good. Median across countries for different regions.

Source: Bruno and Shin (2023); World Bank; IMF, Direction of Trade Statistics; Macrobond; BIS.

Financial channel of EME borrowers' currency mismatches

Dollar weakness can have an impact on risk-taking through currency mismatches on EME borrowers' balance sheets. As the dollar depreciates, the value of non-dollar assets rises compared with dollar liabilities. This strengthens the balance sheets of borrowers with unhedged dollar liabilities. Stronger balance sheets, in turn, shrink the tail of the credit risk distribution, relaxing lenders' value-at-risk constraints. Through this financial channel of the exchange rate, a weaker dollar is typically associated with greater credit supply in dollars and thus easier financial conditions.

The benefits of dollar weakness for EME borrowers can counterbalance the deterioration of trade competitiveness, potentially leading to an overall stimulative impact on EMEs. EMEs that are least reliant on goods exports to the United States (and so least exposed to weaker US import demand) with relatively high short-term foreign currency debt (and so benefiting from a dollar-induced reduction in funding costs) are likely to benefit most. This characterises the situation for a large number of EMEs.

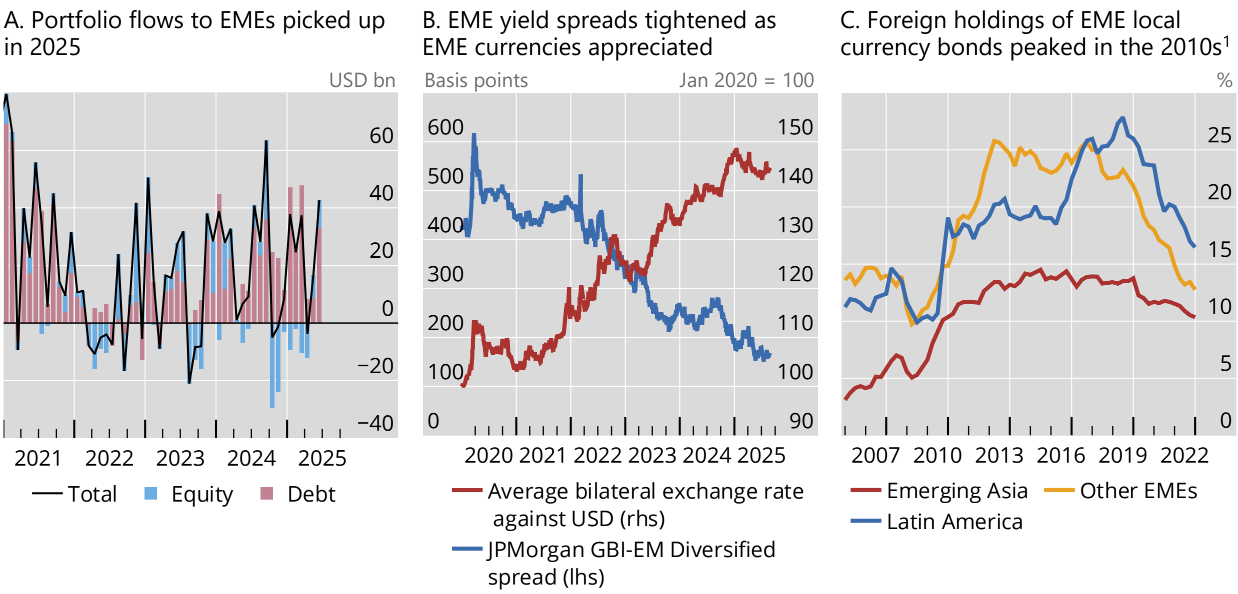
Foreign investors' unhedged portfolio investments

The growth of local currency markets in EMEs has increased attention on the impact that currency mismatches among foreign investors might have on financial conditions. When EME currencies appreciate, unhedged holdings of EME assets gain in dollar terms. For example, higher EME equity returns in local currency are associated with a weaker dollar, indicating that investors who bear dollar risk are compensated with higher expected equity returns (Bruno et al (2022)). The consequent strengthening of investors' balance sheets can induce further investments and result in a mutually reinforcing loop between financial conditions and EME currency appreciation – a loop that also plays out in reverse when the dollar appreciates (Carstens and Shin (2019); Hofmann et al (2022)).

Consistent with past periods of dollar weakness, portfolio inflows to EMEs picked up and domestic financial conditions loosened in 2025, especially during the global risk-on episode that began in late April (Graph 2.A). In bond markets, the appreciation of EME currencies against the US dollar correlated with tighter sovereign yield spreads (Graph 2.B).

Such portfolio inflows could heighten EMEs' vulnerability to spillovers from abroad and pose challenges for financial stability down the road. Yet, so far, inflows to EMEs have not been unusually strong, running a bit above 2024 levels. Furthermore, the share of local currency bonds held by foreign investors is relatively small, below its peak in the 2010s (Graph 2.C).[1]

EME bond markets benefit from a weaker dollar — Graph 2



[1] Asian EME currencies = CNY, IDR, INR, KRW, MYR, THB and TWD; Latin American currencies = ARS, BRL, CLP, COP, MXN and PEN; other EME currencies = BGN, CZK, HUF, PLN, RON, RUB, TRY and ZAR.

Sources: IIF; Bloomberg; Datastream; JPMorgan Chase; national data; BIS.

EMEs as net creditors holding unhedged global portfolios

An aspect of the financial channel that has received less attention is the effect that the exchange rate can have on EME investors' balance sheets. Importantly, for domestic investors with large asset holdings

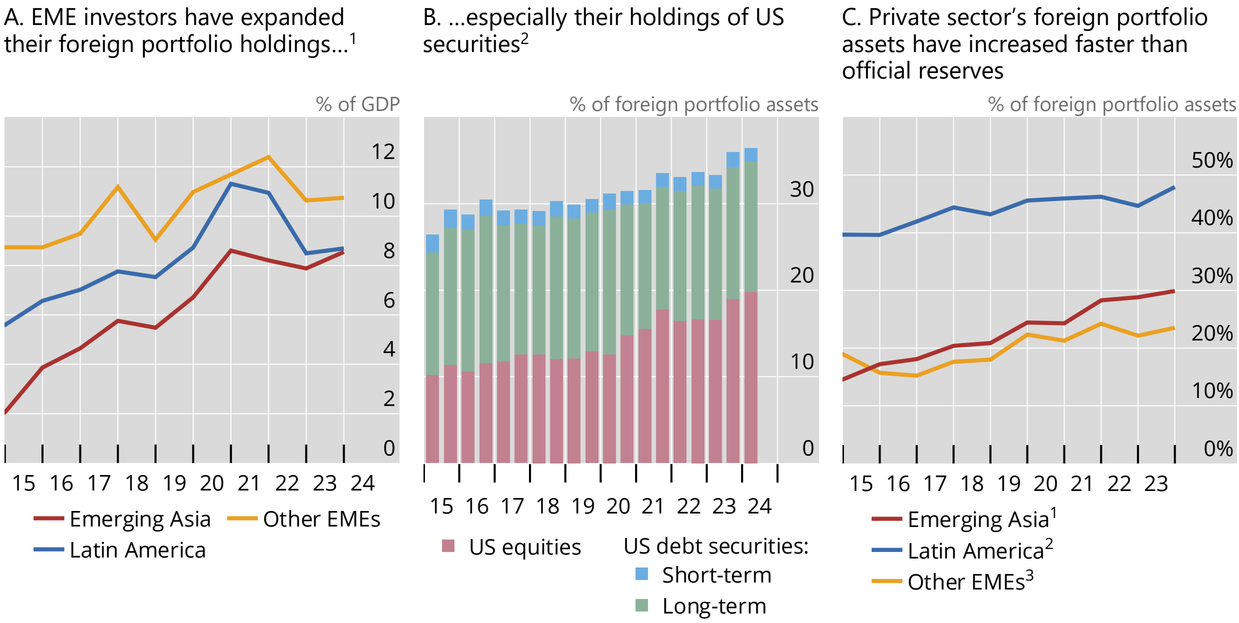
[1] The main reason for the decline in foreign investors' share is that portfolio inflows did not keep pace with government bond issuance during the Covid-19 pandemic. Many advanced economies experienced a similar decline.

denominated in foreign currency, such as banks and other financial institutions investing in US bonds and equities as well as exporters holding onto US dollars instead of converting them, the impact is the opposite of that on foreign investors' balance sheets.

When the dollar depreciates, domestic investors face losses on the unhedged portion of their foreign currency portfolio. These losses can lead to less risk-taking and a tightening of financial conditions. For example, if local portfolio investors increase their FX hedge ratio to stem valuation losses from a weak dollar, the adjustment can exacerbate currency moves, as was seen in April and May 2025 (Shin et al (2025)).

This aspect is rising in importance because of the growth of outward investments from EMEs. In several EMEs, the expansion of the domestic institutional investor base has fuelled an accumulation of foreign securities, particularly dollar assets (Graphs 3.A and 3.B). While official reserves are still the largest component of foreign portfolio holdings, private sector assets are growing more quickly and now account for nearly 50% of Latin America's foreign portfolio assets, 30% of Asia's and about 25% of other EMEs' (Graph 3.C).

EME investors' exposure to foreign markets is growing Graph 3



[1] Emerging Asia = CN, HK, ID, IN, KR, MY, PH, SG and TH. [2] Latin America = AR, BR, CL, CO and MX. [3] Other EMEs = BG, EG, HU, TR and ZA.

Sources: IMF, Portfolio Investment Positions by Counterpart Economy; BIS.

The extent to which domestic investors are exposed to currency fluctuations depends on how much of their foreign assets are hedged. While FX swaps and forwards referencing EME currencies have grown rapidly in recent years (Graph 4.A),[2] EME investors' FX hedge ratios vary over time due to changes in hedging costs and incomplete markets for suitable derivatives.

Furthermore, FX hedge ratios do not tell the full story, as maturity mismatches might still leave domestic investors vulnerable to exchange rate movements. The maturity of the hedging instruments is

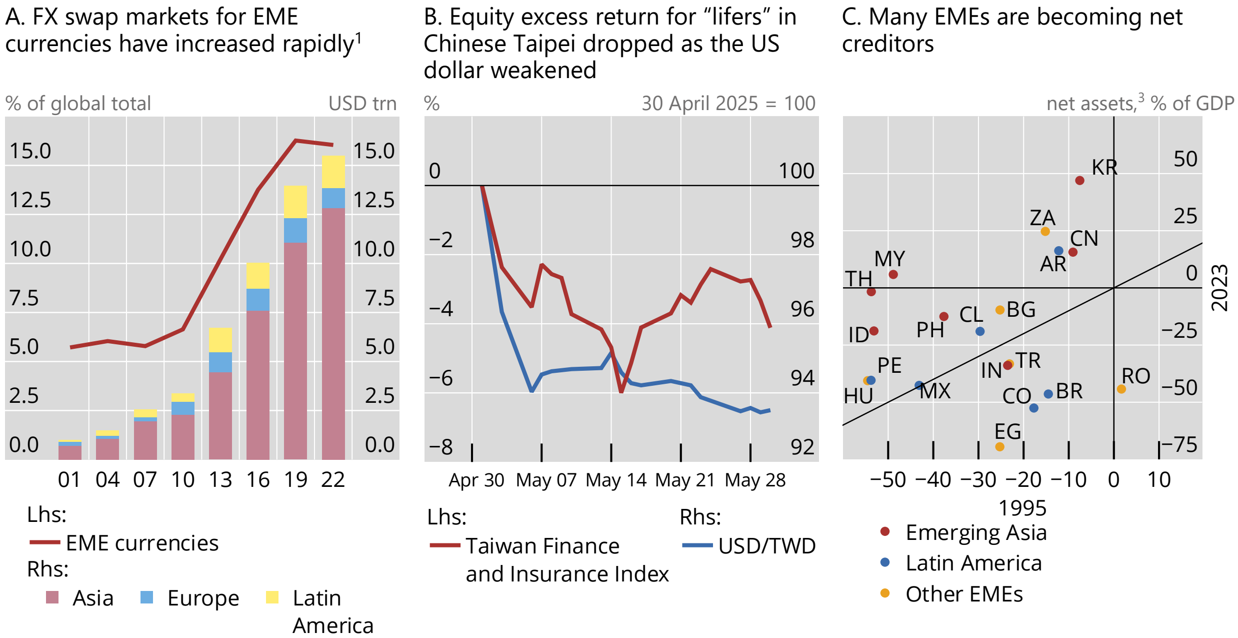
[2] Among EME currencies, non-deliverable forwards have expanded particularly fast.

typically shorter than that of the assets being hedged, and the consequent rollover risk exposes hedged investors to stress in US dollar funding markets (BIS (2025); McGuire et al (2021)). Such risk materialised most recently during the Covid-19 crisis and most dramatically during the Great Financial Crisis, requiring central bank intervention.

The impact of currency mismatches on EME investors' balance sheets is illustrated by movements in the equity prices of life insurance companies in Chinese Taipei in April–May 2025. These companies held sizeable unhedged US dollar assets. When the US dollar depreciated sharply against the New Taiwan dollar in early May, the insurance sector significantly underperformed the benchmark equity index (Graph 4.B), which suggests that the depreciating dollar weakened these companies' financial position.

A weakening of domestic investors' balance sheets can lead to tighter domestic financial conditions through a reduction in risk-taking. For instance, in the Philippines, when the local currency appreciates, banks with more US dollar assets than liabilities tend to reduce their loan supply due to adverse valuation effects on their balance sheets (Bagsic et al (2025)).

EME investors' currency mismatches can alter the financial channel | Graph 4



[1] Notional amount outstanding of FX forwards, FX swaps and currency swaps referencing an EME currency, as of end-June of each year. Data mainly capture derivatives on the balance sheets of onshore dealers and so underestimate the total. [2] Cumulative return in excess of the benchmark index between 30 April and 31 May 2025. [3] Net international financial assets = total external assets excluding gold – total external liabilities.

Sources: Lane and Milesi-Ferretti (2018); Bloomberg; IMF; Brookings External Wealth of Nations database; BIS.

EMEs as net international creditors

On balance, experience suggests that a depreciating dollar is likely to provide a tailwind for the many EMEs where the financial channel dominates the trade channel. This is driven by EME borrowers with foreign currency debt and foreign investors holding EME assets, who gain on the unhedged part of their portfolio. This windfall gain allows them to increase their risk-taking.

But the nature of the financial channel may be changing. Looking to the future, the effects of dollar depreciation may reverse if domestic investors' balance sheets weaken more than those of domestic borrowers or foreign investors strengthen. With the expansion of the domestic institutional investor base over time, many EMEs are gradually moving towards the point where they become net international creditors rather than net debtors, as shown by the number of EMEs above the 45 degree line in Graph 4.C. This is particularly the case in Asia, where some EMEs have already become net creditors. For such economies, the financial tailwind from dollar depreciation experienced in the past may turn into a headwind in the future.

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