



Reducing low-income country debt risks

The role of local currency-denominated loans from international institutions

Jesse Griffiths, Ugo Panizza and Filippo Taddei

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Key messages

- Low-income countries, already facing significant challenges, now face a dramatic worsening of debt sustainability and the possibility of a widespread debt crisis because of the COVID-19 crisis.
- These countries are sensitive to external shocks partly because a large proportion of their debt is held in foreign currency and widespread devaluation of their own currencies has made their debt situation much worse.
- The ability to borrow long term, internationally, in local currency could significantly reduce borrowing risks for low-income countries, but they would need help from multilateral institutions to do so.
- This paper sets out four options as to how this could be done in a way that overcomes challenges, including the institutional rules of multilaterals, political economy problems and issues of moral hazard:
 - Option 1: Multilaterals accept the currency risk themselves
 - Option 2: Multilaterals hedge lending through another institution
 - Option 3: Multilaterals borrow from local capital markets and on-lend
 - Option 4: Multilaterals borrow abroad and on-lend in local currency
- These options should be developed to generate workable proposals for discussion with low-income countries, with a view to identifying how greater availability of local-currency funding could help them reduce debt risks.

Purpose of this paper

This paper contributes to the discussion on how to reduce debt risks for low-income developing countries – an important issue in recent years and now a policy priority as the COVID-19 crisis escalates debt problems. It aims to identify and assess options for increasing the supply of local currency-denominated lending by multilateral institutions to sovereign governments in low-income countries, thus shielding them from risks associated with currency depreciation. It is intended to promote debate and reinvigorate the consideration of serious policy proposals in this neglected but important area at a time when innovative ways of reducing debt risks for low-income countries are of paramount importance.

Background

Public external debt in low-income countries has been rising since 2012. The median public debt of low-income economies¹ rose to 49% of gross domestic product (GDP) in 2019 from 33% in 2013 (IMF, 2020a). The composition of low-income country public debt has changed dramatically in recent years, with declining concessionality and increased borrowing from private, non-traditional official and domestic lenders. While the share of low-income country debt owed to private creditors had more than doubled to nearly 6% of GDP as of 2016, the share of debt owed to bilateral creditor members of the Paris Club was just over 2% of GDP. This compared with nearly 14% of GDP owed to non-Paris Club creditors, with China accounting for just over 4% of GDP. Domestic borrowing has been increasing, reaching more than 15% of GDP as of 2016, a similar level to that borrowed from external multilateral creditors (IMF, 2018: 51).

The COVID-19 crisis will have a massive effect on debt sustainability in developing countries. Higher healthcare costs, lower tax and export revenues and frozen debt markets

will limit governments' ability to cover existing expenditure and refinance their maturing debt. The large capital outflows, currency depreciation, fall in commodity prices and economic slump associated with the COVID-19 crisis are likely to lead to numerous debt crises. These problems are not due to policy failures in the developing world but to external factors, including skyrocketing financing needs in advanced economies, elevated risk aversion among investors and the global economic downturn. The severity of the crisis in emerging and low-income countries has led to calls for widespread debt suspension or cancellation and the International Monetary Fund (IMF) and G20 group of industrialised nations have taken steps in this direction. From when the crisis exploded to 9 April 2020, more than 90 countries had requested or expressed interest in IMF support, around 60% of them low-income countries (IMF, 2020b).

Capital outflows have led to currency depreciations, with significant effects on low-income countries where external debt makes up a major share of total debt. According to the Institute for International Finance, between mid-February and the end of March 2020, emerging economies registered record portfolio outflows totalling more than \$100 billion (IMF, 2020c). To put this in context, total portfolio outflows in the three months after the global financial crisis were about \$20 billion. The latest outflows have been associated with large currency depreciations, which have averaged 15% in a large sample of developing countries, but close to 30% in large emerging economies such as Brazil, Mexico, Russia and South Africa.² Such large depreciations will have negative implications for debt sustainability in countries with large foreign-currency debt. Developing countries, including low-income countries, often have a high proportion of debt denominated in external currency, typically US dollars. In 2017, for example, an average 74% of low-income country debt was denominated in a foreign currency (Panizza and Taddei, 2020: 9). This is still the

1 There are several definitions of what constitutes a 'low-income country'. We have used the IMF definition of 'low-income economy', as it is the broadest, encompassing 76 countries. All IMF citations refer to this grouping (IMF, 2020a: 46).

2 Authors' calculations based on data from the Bank for International Settlements

case, even though domestic debt levels have risen significantly in many low-income countries.

Partly as a result of this external currency-denominated debt, low-income country debt levels are particularly sensitive to external shocks. Debt sustainability analyses confirm that the majority of low-income countries are vulnerable to exchange-rate changes (IMF, 2015) and many are vulnerable to changes in commodity prices. We saw sharp increases in fiscal deficits, for example, following the 2015 commodity-price shock (IMF, 2018: 39). The rise of foreign participation in domestic capital markets means that the risks associated with changes in investor sentiment have grown (Cornford, 2018). Sudden capital outflows caused by external investors' withdrawal from domestic debt markets can lead to both sudden changes in exchange rates and funding shortfalls for countries relying on those markets (IMF, 2018: 50). The COVID-19 economic crisis is on a scale not seen before, so the extent of the external shock to low-income countries will be significant over the course of this year and beyond.

The changing nature of public debt meant that it had already become more expensive and volatile in low-income countries prior to the crisis. This was primarily down to an increase in debt owed to the private sector and an increase in domestic debt as a share of the total. Private debt tends to be significantly more expensive than alternative public lending from international bilateral or multilateral sources and it is also more pro-cyclical (Galindo and Panizza, 2018). Like Mark Twain's proverbial banker, private financiers stand ready to lend you an umbrella when the sun is shining but want it back the minute it starts to rain. As a result, debt-servicing costs are absorbing a growing share of public expenditure (IMF, 2018: 50), with yields spiking in bad times. One analysis using IMF and World Bank data suggests that the 124 developing countries for which data is available spent a mean average 12.2% of government revenue on debt servicing in 2018, up from 6.6% in 2010 (Jubilee Debt Campaign, 2019). Another analysis finds that 29 developing countries devoted

more than 15% of government revenues to debt servicing in 2017, up from 21 countries in 2014 (UNCTAD, 2018: 7).

As a result of increasing debt levels and the rising cost of debt, the number of low-income countries facing serious debt problems was already climbing rapidly and is likely to jump as a result of the COVID-19 crisis. The IMF and World Bank debt sustainability exercise classified 44% of low-income countries as being at high risk of or already in debt distress – a number that has more than doubled since 2013 (IMF, 2020a: 14). Low-income countries are now more integrated into the global economy than before and, consequently, more exposed to market risks because of their greater reliance on private borrowing (IMF, 2015). Foreign-currency bonds are also more likely to involve bullet payments that lead to spikes in financing needs (IMF, 2015), increasing risks and, potentially, refinancing costs. These figures are based on debt sustainability analyses conducted before the COVID-19 crisis. The number of low-income countries in debt distress or at risk of debt distress is, therefore, likely to increase dramatically.

Local-currency borrowing – a key tool for low-income countries

The ability to borrow long term, internationally, in local currency could significantly reduce borrowing risks for low-income countries and help to reduce the likelihood of debt crises. As noted, the large currency depreciations that countries are now experiencing have a dramatic impact on debt sustainability, largely because they owe a considerable proportion of their debt in foreign currencies. A recent study found that debt-to-GDP ratios tend to grow more rapidly when countries that have a high share of foreign-currency debt undergo currency depreciation (Panizza and Taddei, 2020).³ Another advantage of long-term international borrowing in local currency is that it could provide an alternative to borrowing from domestic debt markets. This is especially useful in countries where domestic

3 Panizza and Taddei (2020) do not focus on maturity, but countries need to be careful not to trade currency mismatches for maturity mismatches.

sovereign borrowing levels are high or domestic financial sectors are fragile.

Unlike some emerging markets, low-income countries cannot normally sell their own local-currency bonds to international investors, so are limited in their ability to borrow internationally in their own currencies. There are two main reasons for this. First, credit and currency risk are higher in low-income countries, as these economies are poorer and less diversified than large emerging markets. Second, there is a ‘fixed cost’ involved in gathering information about credit and currency risk, and international investors are only willing to pay this fixed cost if researching a new economy would allow them to access a relatively large and liquid domestic bond market (for evidence, see Eichengreen, Hausmann and Panizza, 2005). In many low-income countries, the domestic bond market is either small and illiquid or non-existent, as bonds are placed directly with domestic banks and there is no trading. This fixed-cost problem is amplified by the presence of market failures that prevent those who pioneer new markets and instruments from getting all the gains of their market-discovery process, as their activities can easily be copied by later adopters.

Low-income countries, therefore, need to rely on international financial institutions to assist them if they are to shift a reasonable portion of their international borrowing into local currency. This could also help them to better manage the scale of local-currency sovereign borrowing in the domestic market.

There are, however, three main challenges and objections to expanding local-currency lending by international financial institutions.

1. *The inability of multilateral financial institutions to accept currency risk.* When these institutions provide ‘non-concessional’ or market-rate loans, their practice is to ensure that lending in domestic currency is offset by an equivalent amount of domestic-currency borrowing. This helps to negate the currency risk, as any losses on one side of the portfolio (lending) are equivalent to gains on

the other side (borrowing), and vice versa. However, in low-income countries, a large share of lending by international institutions is on a concessional basis, meaning there is a grant element that reduces the cost of the lending. Thus, for example, a large share of the concessional lending undertaken by the World Bank’s International Development Association (IDA), which lends to low-income countries, is financed by grants that do not generate a corresponding financial liability for IDA. Hence, IDA’s inability to assume currency risk should not be a constraint on foreign-currency lending.

It is also worth noting that IDA loans have an average maturity of 20 years, and may be as long as 40 years, making an assessment of the currency risk very difficult (IDA, 2020). If the loan is priced fairly, the only thing that matters is the sharing of this risk, and if multilateral lenders have higher risk-bearing capacity than the borrower, it makes sense that the multilaterals should absorb some of this risk.

Current risk-management practices do not help either, as they assign higher capital charges (which define how much capital the multilaterals tie up) to domestic-currency loans. Therefore, a higher share of domestic-currency loans would reduce the amount of lending the multilaterals can undertake, shrinking the size of their portfolios. However, these practices are not written in stone and could be changed if there were the political will to do so. Another issue is that local-currency lending would complicate multilaterals’ asset-liability management (Hoschka, 2005). Again, this is a technical issue that could be solved if there were the political will to move in this direction.⁴

2. *Political economy problems and debt-management capacity in borrowing countries.* To borrow in local currencies implies paying a currency premium (*ex ante*) that incorporates the possibility of a sharp devaluation in future. This is analogous to buying insurance, where you pay a premium

⁴ For a discussion of technical challenges see Hoschka (2005), especially the table on page 9, which lists domestic rating exemptions, broad investor access, risk weightings and reserve eligibility.

in good times so that you are covered should something go wrong down the line. Even if the premium is set fairly (to precisely offset the currency risk), policymakers who care more about the present are likely to disregard negative events that may materialise when they are no longer in office. The probability of a currency devaluation increases over time, so policymakers may find the premium expensive relative to the short-term risks. This helps explain why they would opt for foreign-currency debt with a lower interest rate and leave future governments exposed to currency risk. This problem is compounded by the fact that low-income countries tend to have limited debt-management capacity. Hence, their debt managers may not fully appreciate the costs and benefits of local-currency instruments with an embedded insurance component (Paesani and Piga, 2010). This is why capacity development is important.

3. *Moral hazard*. Increased lending in local currency could generate incentives to reduce the real value of debt by stoking inflation. It is, however, worth noting that many economies have solved this problem by undertaking institutional reforms and creating a domestic constituency that favours low inflation. In fact, a recent study found no correlation between local-currency borrowing and inflation, on average, but a correlation in countries with weak institutions (Panizza and Taddei, 2020). The authors of this study also developed a simple but comprehensive model in which monetary credibility was achieved with a balance of foreign-currency and local-currency debt. Multilaterals could, therefore, balance the share of their total lending in foreign and domestic currency on a country-by-country basis. Indeed, they would have to do this anyway to meet varying levels of demand.

There is a long history of proposals for significantly expanding multilateral local-currency lending to public actors in developing countries. However, they have fallen off the international policy agenda in recent years. Given the rising debt problems in low-income

countries and the upsurge in debt associated with the COVID-19 crisis, it is time to reinvigorate the discussion on how debt risks can be reduced. Examining ways to shift a proportion of international borrowing from external to local currency will be an important part of that discussion. This paper, therefore, puts forward four options for how international institutions might increase their share of local-currency lending in light of the obstacles highlighted and underscores the trade-offs that will need to be carefully considered in taking forward this agenda.

Options assessment

We evaluate four options for reducing the foreign-currency exposure associated with multilateral lending to low-income countries. These options focus on multilateral development bank operations and separate concessional from non-concessional lending. While these options are not appropriate for IMF crisis lending, they could, in principle, be considered for the IMF *Poverty Reduction and Growth Facility*.

Option 1: Multilaterals accept the currency risk themselves

Under Option 1, the multilateral simply retains the currency risk by either making the loan directly in the domestic currency or by transferring foreign currency and requiring repayment in foreign currency at the exchange rate which is prevalent when the loan is due. These two methods are theoretically equivalent. However, from the lender's point of view, transferring foreign currency and requiring repayment in foreign currency is preferable for countries that do not have a fully convertible currency.

While taking on currency risk is problematic for multilaterals, local-currency lending does not violate the Articles of Agreement of IDA, which state that 'the Association may provide financing in such forms and on such terms as it may deem appropriate'.

There are various challenges and caveats associated with switching IDA lending to local currency, however.

- Even if the pricing is fair, local-currency lending may lead to higher *ex ante* interest rates or lower disbursements, so countries may not be interested in switching to local-currency borrowing for the political economy issues mentioned before.
- Most countries receive positive net IDA flows,⁵ so the risk-sharing properties of local-currency lending are not as large as they would be if net flows were negative. In this sense, local-currency lending would be particularly beneficial for countries close to graduation.
- Adverse selection (only countries that think that their currency will depreciate will apply for local-currency loans) and moral hazard (countries with more local-currency debt will have an incentive to debase their currency) will have to be considered during the lending process.
- Local-currency lending (and hedging, as in Option 2) may require an additional ‘use’ of multilateral capital, limiting their lending capacity.

One way to allay the moral-hazard issue would be to index the loan to domestic inflation, as proposed by Hausmann and Rigobon (2003).⁶ This would have the additional advantage of reducing long-run volatility and increasing the predictability of IDA repayments (in the long

run, the real exchange rate is less volatile than the nominal exchange rate). Adverse-selection and moral-hazard concerns could be addressed by ensuring that overall loan portfolios were appropriately balanced between domestic and international currencies. While the political economy problems brought about by short-sighted policymakers would still exist, those politicians should still be happy to borrow a portion of their IDA allocation in domestic currency, given the highly concessional nature of the loans. In other words, while the *ex ante* degree of concessionality would be lower, it could still be large.

Option 2: Multilaterals hedge lending through another institution

Making greater use of currency hedging tools might be another way forward. Hedging products allow the currency risks of lending to be transferred to a third party, for a fee, without affecting the credit risk, which is retained by the lender.

For example, The Currency Exchange Fund (TCX), backed by a large number of multilateral and national development finance institutions, has long experience of providing hedging instruments for currencies devoid of hedging instruments in commercial markets (Hirschhofer, 2019).⁷ Such hedging products could be particularly interesting for regional development

5 The exceptions are countries that are in the process of graduating out of IDA.

6 Hausmann and Rigobon (2003) argued that switching to inflation-indexed local currency would increase the likelihood of repayment, because the debt burden would be larger in good periods and smaller in bad periods, improve risk management for low-income countries and only have a minor overall impact the IDA portfolio’s dollar value. DePlaa and Yi (2005) find that switching to inflation-indexed local currency would, indeed, generate benefits for borrowing countries, as it would greatly reduce the sensitivity of the debt-to-GDP ratio to currency depreciation (according to their estimates, a negative shock to the exchange rate would increase the debt-to-GDP ratio by 0.39 standard deviations under current IDA practices and by 0.07 standard deviations under the Hausmann and Rigobon proposal). However, dePlaa and Yi (2005) find no benefit (but also no cost) to IDA’s portfolio diversification. While economic theory suggests that the real exchange rate of low-income countries should appreciate over time (the Balassa-Samuelson effect), dePlaa and Yi (2005) show that in 1985–2005, the real exchange rate of IDA countries depreciated and that an inflation-indexed local-currency lending programme would have reduced reflows by about \$1 billion. This is not a large amount, considering that over the same period, IDA replenishments amounted to more than \$100 billion.

7 TCX Fund investors include 24 multilateral and bilateral development finance institutions, a group of micro-finance investment vehicles and the Dutch, German, Swiss and United Kingdom governments. Typically, TCX hedges are non-deliverable and settled in hard currency (so the counterparty bears convertibility risk). While TCX does not issue bonds, it promotes local bond-market development by hedging payments of local currency-denominated bonds issued by various development finance institutions.

banks with limited internal diversification capacity, but could also allow global institutions, such as IDA, to experiment with local-currency lending in a limited subset of countries. TCX operates in more than 90 developing countries. Before the coronavirus crisis, it aimed to provide around \$3 billion in ‘exotic’ currency swaps in 2020 and to increase this to \$7 billion in 2022 to allow it to act as market maker, especially in the currencies of low-income countries (TCX, 2018). TCX swaps have no tenor restrictions, so they could also be used to support long-term loan transactions.

The main challenge when it comes to hedging is pricing. While it may be fair *ex post*, it could be considered too high or unaffordable *ex ante*. Borrowing countries could, therefore, require a higher subsidy component in order to choose a local currency-hedged loan over a standard dollar-denominated IDA loan. In addition, all of the financial institutions that offer such products are subject to potential threats to their business model when devaluations are widespread, as they are at present.

Option 3: Multilaterals borrow from local capital markets and on-lend

A third option is to for multilaterals to borrow directly on local capital markets and then lend on these funds to governments. This appears to be a less desirable option, though, as multilaterals are unlikely to have a pricing advantage over governments in their own markets.⁸ Indeed, by entering in these markets, they risk crowding out the private sector in low-income countries with shallow capital markets.

Option 4: Multilaterals borrow abroad and on-lend in local currency

Another alternative would be for multilaterals to borrow internationally in the currencies of the borrowing countries. There are two issues here. First, it may be difficult to convince international investors to lend in exotic currencies. Second, as

is the case on domestic markets, the local-currency pricing advantage of the multilaterals on the international market is likely to be small.

Eichengreen, Hausmann and Panizza (2002) and Eichengreen and Hausmann (2005) make a more interesting proposal. They suggest that the World Bank and other multilateral development banks issue bonds denominated in a real (inflation-indexed) emerging-market currency index and use the proceeds to extend local-currency inflation-indexed loans to their clients. This would have two advantages: (1) it would let the multilaterals lend in local currency (albeit indexed to prices) without taking on currency risk and (2) it could create a market for such instruments, which could then be tapped by other types of issuer. The main issue with this proposal is that the multilaterals would need to be careful in matching their assets (single-currency loans) and liabilities (indexed loans).

Conclusions

The international community and multilateral financial institutions must prioritise finding ways to improve the debt sustainability of low-income countries by reducing the level of currency risk they face. We have looked at the workability of four proposed options in terms of overcoming challenges and obstacles and at how desirable they are for low-income countries. Options 1, 2 and 4 are all potentially useful and should be examined and developed to produce workable proposals in collaboration with low-income countries. If low-income countries are to emerge from the current crisis and avoid potentially debilitating sovereign-debt crises, new mechanisms and ways of working will have to be found to reduce their debt risk. The development of local currency-denominated loans by international institutions is one important response and should be put back on the policy table.

⁸ In theory, the multilaterals should be able to borrow at cheaper rates than their clients, which have higher credit risk. In practice, this is rarely the case. Even when there is a pricing advantage in local-currency terms, this is much lower than the pricing advantage in foreign currency (Perry, 2009).

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