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Local currency financing: an essential component of development financing

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The amount of international financing channeled towards developing countries and emerging economies continues to grow, through both improved access to international financial markets and increased public spending on development assistance (with ODA increasing by 8.9% in 2016). In both cases, the predominant source of funds (from the perspective of partner countries) is financing in foreign currencies like USD or EUR.

Foreign-currency loans can imply significant exchange-rate risks

In theory, a flexible exchange rate should balance out differences between two countries' rates of inflation precisely, so that purchasing power parity is always preserved. In such a scenario, it does not matter which currency a loan is denominated in. The reality is much more complicated, however: exchange rates are not only affected by current prices, but are also heavily influenced by expectations (e.g. with regard to changes in the cost of raw materials) and by speculative financial transactions or political and economic crises. In addition, the currencies of many developing countries are not fully convertible. As a result, the exchange rate may diverge significantly from purchasing power parity, even for lengthy periods, and this can mean that countries or companies (through no fault of their own, and with no ability to influence the situation) are suddenly required to raise significantly more domestic purchasing power than expected to service their foreign-currency debts. Even when purchasing parity is preserved, problems can arise when, for political reasons or due to a lack of market power, borrowers cannot pass purely nominal depreciations in the local currency on to their customers in the form of price increases in the local currency. In the worst-case scenario, there is an insolvency risk.

Developing countries often have very limited options for market-based mitigation of exchange-rate risk

Exchange-rate risks are an inherent feature of international product and capital markets, and are usually compensated through currency swaps or resold on the market in exchange for payment of a corresponding risk premium.

However, for poorer developing countries and the companies based there, these opportunities for risk mitigation are few and far between, either because their currencies are not readily marketable or because the risk premiums are so high that such payments are no longer "worthwhile" from the borrower's perspective. Borrowers also frequently underestimate foreign exchange risk, and are therefore not prepared to accept economically justifiable risk premiums. Even the "TCX Fund", established a few years ago for the specific purpose of mitigating foreign exchange risk for loans to companies in developing countries, can only shift the boundaries of market-based risk mitigation slightly in the right direction without endangering its own risk-bearing capacity and economic viability.

Investment funds in which public and private resources are pooled to finance development-oriented and economically viable investments in developing countries can take on foreign exchange risk (to a certain extent) even without swaps: for example, they might choose to diversify through large volumes and a regional spread, or pursue other options such as structuring separate tranches to absorb foreign exchange risk. While these options provide a certain degree of flexibility in dealing with exchange-rate risks, they can only be used in a small number of specific cases.

Overall then, the options for developing countries and the companies based there to mitigate their exchange-rate risk are very limited, and impose significant restrictions on their financing capacity. However, there are solutions for these challenges as well (see below).

Exchange-rate risks can be avoided in the long term by promoting local finance and capital markets

One "elegant" solution to this problem would be to acquire the necessary funds directly from local finance and capital markets in the local currency, so that no exchange-rate risk even arises in the first place. However, this means local finance and capital markets need to be sufficiently well-developed to generate and efficiently manage the necessary funds: local banks must have sufficient liquidity and be able to assess credit risks reliably. By promoting equity markets (stock markets) and bond issues, e.g. through public anchor investments, institutional investors like pension funds and insurers can mobilise local capital to finance small and medium-sized enterprises (SMEs) and the partner countries themselves, while risk-averse investors can be guided towards new investment classes on a sustainable basis. Guarantees for banks and investors can protect them from default risks from borrowers and bond issuers.
So promoting local finance and capital markets is a high-priority task for international development cooperation, but also requires perseverance as well as stable political and macroeconomic conditions.

In the short term, local currency financing should be expanded

Even in the short term though, development aid donors can offer relief by assuming exchange-rate risk (i.e. by expanding the options for local currency financing): assuming the exchange-rate risk could be part of the donor's contribution, thereby increasing the real value of the aid provided. Other possibilities would include creating budgets for subsidising swap costs, or increased use of guarantee instruments at local level as well.

Note: This paper reflects the opinion of the authors and does not necessarily represent the position of KfW.