



# NIFTYS

## A multilateral solution to hedging currency risk in developing country finance

*Currency risk poses huge risks to developing and emerging economies*

The ongoing COVID-19 crisis has once again highlighted vulnerabilities of developing economies. Even after the bounce-back in the second half of 2020, the year still saw [9 currencies](#) of developing and emerging economies depreciate by over 25%, and a further 21 fell by over 10%. This kind of violent volatility of exchange rates has large macro consequences for developing economies, given that nearly [90% of cross-border debt](#) to low and lower middle-income countries is denominated in hard currencies, mostly dollars.

Hard currency denominated debt of borrowers all developing and emerging economies stands at \$6 trillion, of which low and lower-middle income countries account for about \$2 trillion. Currency depreciations [increase the real cost](#) of this hard currency debt, sometimes making it unserviceable, and triggering debt distress. According to a recent [empirical study](#) on the subject, “the effect on external indebtedness is humongous”. Unhedged currency risk poses one of the biggest threats to the finances of developing and emerging economies, is set to rise dramatically as investments to

tackle climate change, and meet the SDGs ramp up in the decade to 2030.

**To reduce the exposure of developing country borrowers (and external lenders) to currency risks and related macroeconomic fragility, we propose a multilateral International Currency Fund (ICF), to provide hedging capacity and support the creation of currency risk markets. The ICF will provide transparent two-way markets in currencies, allowing international borrowers and lenders to understand, price, quantify and mitigate currency risk, while improving incentives to borrow and lend responsibly. It will build on the successful experience of [TCX](#), a currency risk specialist. ICF fits well into SDG 17, that supports the implementation of the other SDGs, and should aim to cut unhedged currency risk for low and lower middle-income countries by half by the year 2030.**

*Financial flows, both public and private, to developing countries leave the least sophisticated economies carrying FX risk*

The [original sin](#), a term coined to represent the dangers for countries being unable to borrow in their own currency, remains real for most poorer and smaller developing economies where nearly all

borrowing from international investors is still dollar denominated. Private investors unwilling to lend in local currency is one thing, but even international financial institutions (IFIs) including [multilateral development banks](#) (MDBs) and development finance institutions (DFIs) lend mostly in dollars. Between 80% and 90% of all DFI funding, for example, remains denominated in hard currencies.

Rather than financially sophisticated and deep pocketed institutional investors and IFIs bearing it, currency risk ends up being carried by borrowers in developing economies with limited financial sophistication and little risk bearing capacity. This unhedged FX risk is a significant contributor to the fragility of developing economies. Often it manifests itself when countries are at their most vulnerable with capital outflows, market selloffs and sharp depreciations reinforcing each in downward spirals.

Such risk has played a significant role in the build-up of low-income country debts that had to be rescheduled or restructured as part of the HIPC (Heavily Indebted Poor Country) initiative, the MDRI (Multilateral Debt Relief Initiative), and the ongoing Debt Service Suspension Initiative (DSSI). As the [European Central Bank](#) has shown, even EU member states have limited capacity to manage unhedged foreign currency borrowing. Expecting poor economies to carry this risk is asking for trouble.

More than 90 countries have had to restructure over [\\$600 billion](#) of public sector debt. This has inflicted considerable losses on creditors, and disrupted market access for borrowers leading to large welfare losses. The past 13 months have already seen [six sovereign defaults](#) in Latin

America alone, with over \$80 billion of debt having to be restructured.

Despite the risks, hard currency borrowing by developing economies hit a new record of \$726 billion in 2020 according to data provider Refinitiv, as countries scrambled to mobilize funds to fight COVID. With this comes increased risk of restructurings, creditor losses, and fragility for borrowers unless currency risk is mitigated. This is not sustainable SDG financing.

Given the large funding needs to tackle climate change, meet the SDGs and make productive investments, cross-border finance is set to rise dramatically, so a better pricing, management and mitigation of currency risk will deliver large benefits to the population of debtor countries. Better currency risk management also improves the credit quality and resilience of borrowers, which is also good for creditors.

*Burdening unsophisticated borrowers with currency risk is the result of both market and policy failure*

By some measures, the currency market is the largest market in the world with a [daily trading volume](#) of \$6.6 trillion. But it is highly concentrated with the dollar accounting for nearly half of all volume and the euro and other G-10 currencies making up much of the balance. Even the Chinese RMB, the most traded developing economy currency, accounts for only 2.15% of volume, less than the Swiss Franc, despite the Chinese economy being more than 20 times larger. All low-income countries put together account for less than 0.2% of currency trading volume.

The private market in currency hedging for (most) developing countries has failed to develop and is practically non-existent

for low-income economies. The few transactions that do occur are mostly for the very short term and are expensive. These currency markets are trapped in a bad equilibrium of thin liquidity, limited demand, scarce supply, and high costs. Only for about 20 developing economies is it possible to get [private market pricing](#) for 3-year swaps, with the list nearly halving at the 10-year maturity.

But there is also policy failure. The international financial and development finance architecture evolved unevenly in the years following the end of the [Bretton Woods system](#) of fixed exchange rate regimes. Most countries now follow some form of a flexible exchange rate regime. Despite this, all IFIs, continue to provide most of their loans with debt service fixed in hard currencies burdening borrowers with all currency risk. Institutional investors follow suit and developing economies end up with large currency risks they have little capacity to carry.

*Risk transparency and market discipline are needed*

Even concessional hard currency loans at 1% can end up being very expensive when currencies fall against the dollar. [For example](#), an 18-month period from January 2017 saw the currencies of Ghana, Nigeria, Zambia, Ethiopia, DR Congo, and Angola fall by 14%, 16%, 18%, 19%, 28% and 47% respectively.

But in the absence of transparent forward pricing of currencies, it becomes impossible to accurately compare a supposedly concessional 1% 10-year dollar loan from the World Bank with an 8% 10-year loan denominated in the local currency, which may be less risky, and cheaper for the borrower in the long run. With annual interest differentials between

local and foreign currency debt [ranging from](#) 4% to 14%, this is not a hypothetical example.

Indeed, seemingly low-priced loans in the wrong currency are dangerous because they encourage speculation, even when it may not be explicit. As a [recent paper](#) points out, this is the equivalent of developing country governments and corporates engaging in a “carry trade”. This is one of the riskiest trading strategies in finance, also often described as picking pennies in front of a steamroller.

The lower upfront interest cost of hard currency bonds and loans is tempting for politicians, corporates and decision-makers who often have a short-term horizon that incentivizes taking on hard currency debt with lower upfront costs despite it being more expensive in the long term.

*An International Currency Fund can address these problems*

A multilateral International Currency Fund can address this colossal market and policy failures by acting as a market maker for developing economy currency risk on a global scale. In many currencies and countries, the ICF would fill in for private markets, which often don't exist. The ICF's mandate to transparently price long-term currency risks and support the creation of risk markets would likely crowd in commercial actors that each bring additional hedging capacity and diversity. The creation and growth of sufficiently deep risk markets would in turn allow development and commercial lenders to offer loans and buy bonds indexed to the local currencies of their borrowers.

The ICF would complement existing Bretton Woods Institutions, updating the landscape for the era of flexible exchange rates by providing two-way currency pricing and hedging markets for currencies and tenors where private markets have not yet been established. Like them, it would have a wide-ranging membership, preferably universal. It would be a treaty-based international organization with a preferred creditor status capitalized with a mix of paid-in and callable capital like the IBRD.

*The ICF would build on the success of TCX*

In its operations, the ICF would build on the successful experience and expertise of [TCX](#), a donor supported financial institution that specializes in currency risk. TCX provides currency risk pricing, and long-term hedging solutions in some [90 developing country currencies](#) and has an active swap portfolio of about \$3.5 billion on a modest capital base of 1 billion.

TCX's currency pricing models and risk management have been successfully stress tested in the real world through the euro crisis, the taper tantrum and the covid crisis through all of which, the institution has managed to remain [modestly profitable](#) despite wild swings in currency markets. Using these as the basis for ICF's operations would minimize implementation and operational risks and enable a rapid scale-up.

Every country has some entities that earn foreign exchange, and others with hard currency borrowing, but revenues in the domestic currency. In a well-functioning market, these entities would all find each other to net their exposures out, but many developing countries have no such markets. A multilateral ICF would assist investors, borrowers, donors, corporates,

remitters of foreign exchange and commercial intermediaries, by acting as counterparty and making markets to net their exposure out.

At present, TCX offsets 45%-55% of its long exposures. We expect that ICF will achieve an even higher ratio, perhaps as large as 75%. Its larger size and order flow, and multilateral status will likely create more offsetting opportunities. In carrying the residual risk that cannot be offset, TCX has experienced the benefits of diversification that exposure to multiple currencies brings and the ICF will also benefit from lower portfolio level risk.

Aided by its multilateral and preferred creditor status, the ICF could also start offering deliverable currency products onshore, rather than just the non-deliverable forwards that TCX is currently able to offer. This would further aid local risk market developments and liquidity making ICF more efficient and effective in its aim to mitigate currency risk. The larger size and transparent pricing of currency markets is also likely to attract institutional investors that see currency risk as an alternative asset class.

The preferred creditor status, multilateral imprimatur, and sterling credit rating would make ICF the counterparty of choice, reduce collateral requirements, and thus further improve efficiency over the current TCX model.

New risk markets created with the help of the ICF would provide sharper, and timely, feedback to national policy makers, than is available through eurobond markets, as forward currency pricing moves in response to changing policy and market conditions. Both IMF and the World Bank have the required surveillance, policy and

funding capacity to help governments adapt policy and respond appropriately to market signals.

Well-functioning currency risk markets are crucial for the success of the Billions to Trillions agenda, that envisages most future funding for developing economies will come from private, not public sources.

#### *How do we get there?*

The global community has committed to achieving the SDGs. But large, poorly allocated and badly mis-managed currency risk in lending to developing economies poses a threat to the poor and the achievement of SDGs 1 and 10. Without addressing and mitigating this currency risk, it would also be nearly impossible to deliver on SDG 13 (climate action) and SDG 7 (providing clean and affordable energy) as both require large upfront investments.

Shifting currency risks away from borrowing countries towards global risk markets fits well into SDG 17, that enables the implementation of other SDGs through partnerships. Specifically, we propose that at least half of all currency risk borne by developing economies, particularly all low and lower middle-income ones should be hedged by 2030.

These economies carry around \$2 trillion of unhedged currency risk today, most of it at the sovereign level, which may, according to our estimates, reach \$6 trillion by 2030 if the ambitions of the SDGs and limiting global warming to 1.5 degrees, are to be met.

To accommodate such hedging volumes in thinly traded developing economy currencies, large risk markets need to be created. The ICF therefore needs to be of

a sufficiently large size to signal a seriousness of intent, trigger the desired private involvement, and provide macroeconomically significant hedging capacity that would meaningfully reduce the fragility and risk faced by these economies.

Offsetting risk, diversification and prudent risk management allow TCX to carry \$5 of gross currency risk exposure for every \$1 of capital but scale economies and a multilateral status would likely allow the ICF to carry twice as much risk for every unit of capital.

Thus, for the ICF to carry a gross currency book of \$250 billion, the minimum risk capacity we recommend at launch, it would need to have a capitalization of around \$25 billion. Less than \$5 billion of this capital would need to be paid upfront, with the rest taking the form of [callable capital](#), that is used to also support MDBs. Scaling up from this level will be necessary, but simple to execute, as demand for hedging picks up with MDBs and market norms switching to local currency lending or fully hedged hard currency lending as the default.

This scale up will depend on how successful the ICF, and associated efforts to create private hedging markets in currencies and tenors which are currently not quoted will be. The answers will depend on global risk appetite, the macro-financial environment, the effectiveness with which the ICF conducts its mission to support market creation, and other supporting policy initiatives. Given that more than 80% of all outstanding bonds now trade at negative real yields, the search for yield and related interest in developing emerging and frontier economies is likely to keep rising for long.

In the past few years, we have observed increasing appetite for frontier and emerging market currency risk, interrupted briefly by the COVID sell-off in spring 2020, but the appetite has been limited. This is a chicken and egg problem wherein the volume of opportunities available is too small to move the needle on risk and return for large investors such as the \$1.36 trillion Norwegian sovereign wealth fund but without more capital from both the private and public sector the opportunities won't scale.

This is another reason to be ambitious in the scale and scope of the ICF's launch as the seriousness of intent, and large size will unlock private capital from larger and long-term investors who can see the expanding contribution to global GDP from developing economies. And, if the ICF is successful in its mission to create risk markets, additional capital requirements to cut unhedged currency risk by half by 2030 will be modest.

Donors may need to provide blending facilities to help pay for the up-front costs of hedging for some of the poorest economies. But these subsidies ought to pay for themselves through lower risks, and eventually lower cost of financing for borrowers and through lower losses for lenders as the need to restructure unserviceable debts falls. The COVID crisis has reinforced the basic wisdom that prevention is much cheaper than the cure.

While the hedging capacity offered by the ICF will provide tangible, macro-significant benefits in terms of risk reduction, we believe that the biggest impact of the ICF will come from the transparent pricing of currency risk and the effect this has on improving lending practices and policy

making. The price signals will not only facilitate a better measurement, management, and mitigation of currency risk by both borrowers and lenders but should also create the incentives for more responsible policy making. These will reduce the intrinsic risk associated with developing economy currencies, making it easier and cheaper to provide.

The launch of the ICF, together with the increasing mobilization of local savings and improving market discipline and macroeconomic policy in developing economies should dramatically reduce currency risk currently borne by developing economies. The resulting greater resilience and stability will significantly improve the amount of external funding available for the SDGs and investments in developing economies, while simultaneously improving the terms of this funding as macroeconomic risk and currency volatility fall.

Together with the fight against climate change, and COVID, the creation of ICF reflects a new multilateralism, a revival of the spirit of Bretton Woods. The time for such a bold move is now, or it will be too late.

***This brief is part of the NIFTYS Policymaker notes series "Big Solutions for Big Problems".***

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