Why hard-currency infrastructure funding is so last century

Hard-currency finance still dominates financing flows from development finance institutions (DFIs) and other impact lenders into low and middle-income countries. Unfortunately, however, given the often very volatile exchange rates in such countries, the volume of local currency required to service hard-currency debt, will be very hard to predict and typically increase significantly over time.

The effects of significant depreciation in an economy carrying a large hard-currency public and/or private debt stock are multiple; they may include financial distress at borrower levels, increased non-performing loans in the financial sector and a resulting credit freeze, fiscal difficulties with numerous trickle-down effects, increased utility tariffs, imported inflation and a resulting higher cost of living, reduced foreign investor confidence and so forth.

There is, therefore, arguably a serious flaw in hard-currency-denominated development finance, as the exchange rate risk that comes with it may partially undo the intended positive development impact.

When development finance emerged mid-last century, with its initial heavy bias towards infrastructure, there were no realistic alternatives to USD funding, nor did foreign investors wish to take any exchange rate risk. As a result, governments and parastatals borrowed in hard currency to fund public sector infrastructure investments. Meanwhile, international private infrastructure developers insisted on having USD indexed off-

take agreements - where the buying utility, typically a power or water utility or other buying public entity bears the long-term exchange-rate risk - and accordingly, as the revenue under the off-take agreement is USD linked, would also fund their projects with hard-currency debt. This became the norm for many decades.

The intervening period has, however, seen conditions for local-currency financing dramatically improve. Target markets themselves have grown in depth and structure, as savings cultures have evolved and capital markets have developed. There is also a greater availability of instruments designed to unlock those markets, such as DFI guarantee programs and other capital-market development initiatives. GuarantCo[1], which provides guarantees to support *locally* sourced local-currency funding of infrastructure development, is one such example. International hedge markets have also developed, including the reach of commercial banks into emerging markets and the creation of specialized hedging instruments like The Currency Exchange Fund (TCX)[1], that offers currency hedges without tenor limitations in developing countries. In short, the availability of local-currency finance has substantially increased, both from domestic and from international sources.

This increase is reflected in a steady rise of local-currency transactions across many sectors, with the microfinance and SME sectors having seen the largest rise. That local currency has become the default choice in these sectors is due to several factors, including regulation, generally preventing hard-currency lending to local-currency earning customers, lender concerns with social impact and the establishment of TCX that offers the required hedging products to development and impact lenders covering these markets.

The greater incidence of local-currency transactions beyond microfinance, demonstrates that the *supply* of local-currency funding products is not necessarily a constraint anymore, also for other sectors. Recent examples showcase this, we cite a few: several local-currency loans to off-grid solar distribution companies including a USD 85 million Kenyan shilling facility from Kenyan and international banks for M-Kopa and a USD 20 million Rwandan franc loan by a Rwandan bank to Bboxx; USD 60 million 5-10 year Indian rupee and Philippine peso bonds issued by a renewable energy developer and guaranteed by GuarantCo; a series of transactions supported by TCX hedges, including a 9 year USD 35 million Georgian lari loan to the Georgian water utility, a 9 year USD 50 million peso loan for a Argentinian public transportation project, an 8 year USD 20 million loan for a Nigerian university project and over USD 100 million of long-term local-currency loans to power utilities in Uruguay, Costa Rica and Jamaica.

The above suggests that supply-side constraints are being addressed and that the dominance of hard currency is demand-side driven, particularly in the infrastructure sector. Persistent beliefs around the availability of local currency, such as, its relative cost, the presumed need for hard-currency debt to fund hard-currency equipment purchases and fears around volume and tenor availability, may play a role here. A few misconceptions should be addressed. Firstly, there is no empirical evidence supporting the notion that local currency is generally more expensive than hard currency. On the contrary, for the required long-term financing structures needed for most infrastructure projects, local currency is, over time, generally the most cost-effective solution. Secondly, dollar denominated equipment purchases do not necessitate dollar debt,

[1] TCX and GuarantCo are both managed by the Cardano Development group. TCX's hedge products and GuarantCo's guarantee products have collectively supported in excess of USD10 billon of local-currency development finance in 70+ currencies.

they simply mandate the purchase of dollars at some point to make payments. Regarding tenors and volumes, the previous examples show that the range of tenors and volumes - across multiple currencies - is such that they are competitive with the dollar alternative.

In summary, many reasons that once ruled out local currency, no longer stand today.

One key driver of the persistence of hard-currency infrastructure funding in developing markets, is the hard-currency off-take agreement model, where exchange rate risk is borne by the off-taker, e.g. the national power utility. Project developers, investors, lenders and even host governments have become so accustomed to this model, that it is now hard to depart from. The USD off-take agreement conundrum, i.e. that energy supply in the poorest countries is financed with hard currency, associated often with great economic, social and political cost, can be tackled in different ways. One is to move towards local-currency off-take agreements and hence to local-currency project finance, which will stimulate local debt and capital markets to the extent available and otherwise take the fx risk outside the country and onto the books of foreign lenders and/or their hedge providers. To avoid industry disruption, however, this would have to be phased-in gradually, allowing stakeholders to adapt, and debt and hedge markets to adjust and scale-up. An example of this gradual approach is seen in Nepal, where projects below a certain MW threshold are given a rupee off-take contract. Another way is to hedge a utility's currency mismatch resulting from USD off-take agreements. TCX and GuarantCo are working with several African utilities towards that objective.

The above described developments and the examples given, demonstrate that long-term local-currency lending to infrastructure sectors in developing countries is possible and is happening. And that is encouraging and necessary. Given the systemic risk that comes with hard-currency finance and given the enormous funding volumes that emerging and developing countries will be taking on to develop their infrastructure sectors, a continued exclusive reliance on hard currency is not sustainable. Over time, the development of international and domestic local-currency markets and the changing attitude of all stakeholders, will have to move hand-in-hand and step-by-step to realize a gradual but vital transition to a much greater share of local currency in the financing of infrastructure sectors and of developing economies in general.

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