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OPINION

Development Banks Should Reform Their Lending Practices

By Alexander Kozul-Wright and Ruurd Brouwer

The International Monetary Fund (IMF) and the World Bank share a common goal of raising living standards in their member countries. This week, the two international institutions will convene in Washington DC (through October 16) for their annual meeting. The strength of the US dollar will be a key talking point. By adjusting their lending practices, these institutions have a unique opportunity to relieve suffering in the world's poorest countries.

GENEVA, Oct 11 2022 (IPS) - In the last week of September, emerging market (EM) bond fund outflows hit $4.2 billion, according to JP Morgan, bringing this year's total to a record $70 billion. The exodus, set off by a rising U.S. dollar, is heaping pressure on low-income countries.

The greenback's rise has been fuelled by interest-rate hikes by the Federal Reserve. Since March, the Fed has raised rates by three percentage points, prompting global investors to move their funds into U.S. financial assets and away from (riskier) EM investments.

While economists continue to wrangle over their U.S. growth forecasts, this 'flight to quality' has sent financial shockwaves across the developing world, already straining under elevated costs for food and fuel – typically priced in U.S. dollars. Moreover, attempts by EM policy makers to stem the dollar's rise have largely failed.

Over the course of this year, central banks around the world have drained their U.S. dollar reserves at the fastest rate since 2008. To stem currency depreciations, they have also raised interest rates aggressively. In Argentina, for instance, policy makers raised rates to 75% last month. To little avail.

The MSCI Emerging Market Currency Index, which measures the total return of 25 emerging market currencies against the U.S. Dollar, is down nearly 9 percent from January 1st. The Egyptian pound has depreciated by 20% over the same period, according to Bloomberg data. In Ghana, the Cedi has fallen by 41%.

On top of higher imports costs, a plunging currency makes the servicing of dollar- denominated debt more expensive. This concern may seem abstract to people in advanced economies. In developing nations, however, the effects are painfully real.

As the dollar appreciates relative to other currencies, more domestic currency (in the form of tax revenues) has to be generated to service existing dollar debts. For low-income governments, budget cuts have to be implemented in the hope of avoiding sovereign default.

Currency depreciations have the power to strongarm authorities into reducing health and education spending, just to stay current on their debts. This leaves officials with a grim choice: either risk unleashing a full-blown debt crisis, or confiscate essential public services.

Given the painful costs of insolvency, governments tend to prioritize austerity over bankruptcy. Together with the oft-publicized effects of lost access to foreign investment, subdued growth and high unemployment, sovereign default also imposes severe social tolls.

In August, the World Bank published a paper measuring the decline in country living standards – looking at access to food, energy and healthcare – after state bankruptcies. The paper showed that ten years after default, countries experience 13% more infant deaths per year, on average, compared to the synthetic control (counterfactual) group.

Admittedly, more developed emerging markets like Brazil and India can issue bonds in their own currency to limit budget cutbacks. In most of the world's poor countries, however, financial markets are too shallow to support domestic lending.

With no recourse to borrow from private creditors, public bodies like multi-lateral development banks (MDBs) usually step in to fill the gap. Indeed, almost 90% of low-income countries' (LICs) funding takes the form of concessional, or non-commercial, loans from official lenders.

Even accounting for these favourable terms, financial pressures are beginning to build outside of well-known hot spots like Lebanon, Sri Lanka and Pakistan. As it stands, LICs have outstanding debts to MDBs and other official creditors to the tune of $153 billion (mostly denominated in USD).

Given the exogenous trigger for capital outflows from developing countries this year, multi-lateral lenders need to be more innovative. Where possible, they should use their robust credit ratings to assume greater risk by lending to poor countries in domestic currencies.

Failing that, they could lend in synthetic local currencies. These instruments index dollar debts to local exchange rates, allowing borrowers to service liabilities in their own currency while ensuring that creditors receive payments (both interest and principal) in dollars.

Synthetic currencies can improve debtor credit profiles by limiting foreign capital outflows and, by extension, improve debt management capacity. In particular, they boost economic resiliency by making government finances less a function of international currency volatility.

Multilateral financial institutions have been tasked with designing a stable international monetary system to try and ease global poverty. But the loans provided by these groups undermine their own mission, as dollar debts force currency risk onto the countries least able to handle it.
This week, the World Bank and the IMF will convene in Washington (October 10-16) for their annual meeting. The strength of the USD will be a key talking point. By adjusting their lending practices, these institutions have a unique opportunity to relieve suffering in the world's poorest countries.

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