FT Alphaville Currencies

It’s the currency, stupid

Breaking the debt doom loop

Danger dollar © Bloomberg

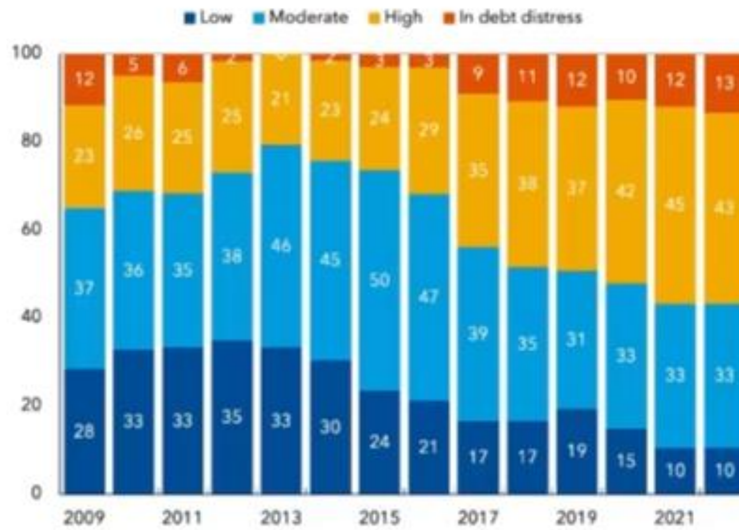
Ruurd Brouwer – January 18th, 2023

Ruurd Brouwer is the chief executive of TCX, a currency hedging fund set up by several development banks to help developing countries ameliorate FX risks.

In last week’s FT, Martin Wolf made a just case that high income countries should support emerging and developing economies to prevent the next debt crisis.

> *Covid was not these countries’ fault. The lack of global co-operation in tackling it was not their fault. The lack of adequate external official funding was not their fault. The global inflation was not their fault. The war is not their fault. But if the high-income countries do not offer the help they now evidently need, it will unambiguously be their fault.*

Zambia, Lebanon, Sri Lanka and recently Ghana are leading the way, but the number of countries at (high risk) of debt distress has been on the rise for quite some time — as this IMF chart shows.



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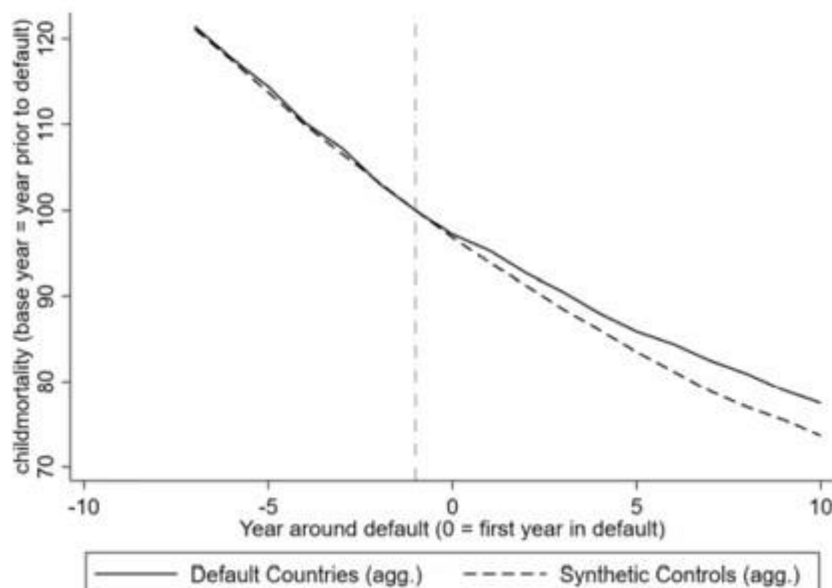
This matters in so many ways. Preventing debt crises even saves lives.

Last year, the World Bank studied the effect of 131 sovereign defaults since 1900. They learned that in the short term the number of people living in poverty shoots up 30 per cent, but even a decade later defaulters have 13 per cent more infant deaths every year, whilst surviving infants have a lower remaining life expectancy.



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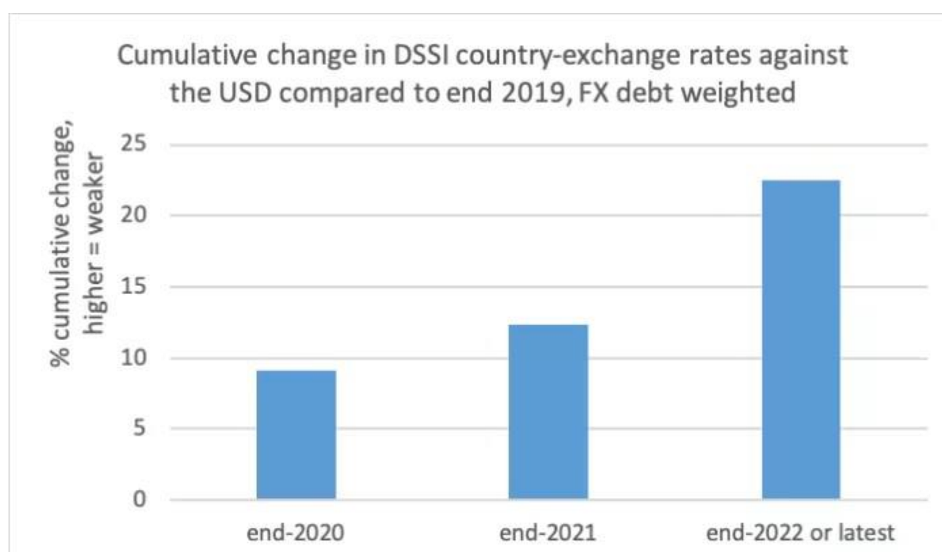

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The most recent big initiative to help the poorest countries manage their debts was the G20 Debt Service Suspension Initiative (DSSI). Paying later would prevent countries from defaulting whilst freeing up liquidity to fight the Covid pandemic. And it would buy time to address structural debt problems.

Out of the 73 countries that were allowed to use the DSSI, 45 actually did. A total of $12.9bn of debt servicing was suspended by official creditors in 2020 and 2021.

The initiative fulfilled its short-term purpose of providing at least some relief. But that’s only one side of the debt coin. It is the tail side that defines success.

As poor countries have shallow capital markets, their long-term funding usually comes from foreign lenders, in foreign, hard currency, mainly US dollars. But borrowing in a currency that you don’t control is rightly called the “original sin” of sovereign debt markets, and has through history proven dangerous.

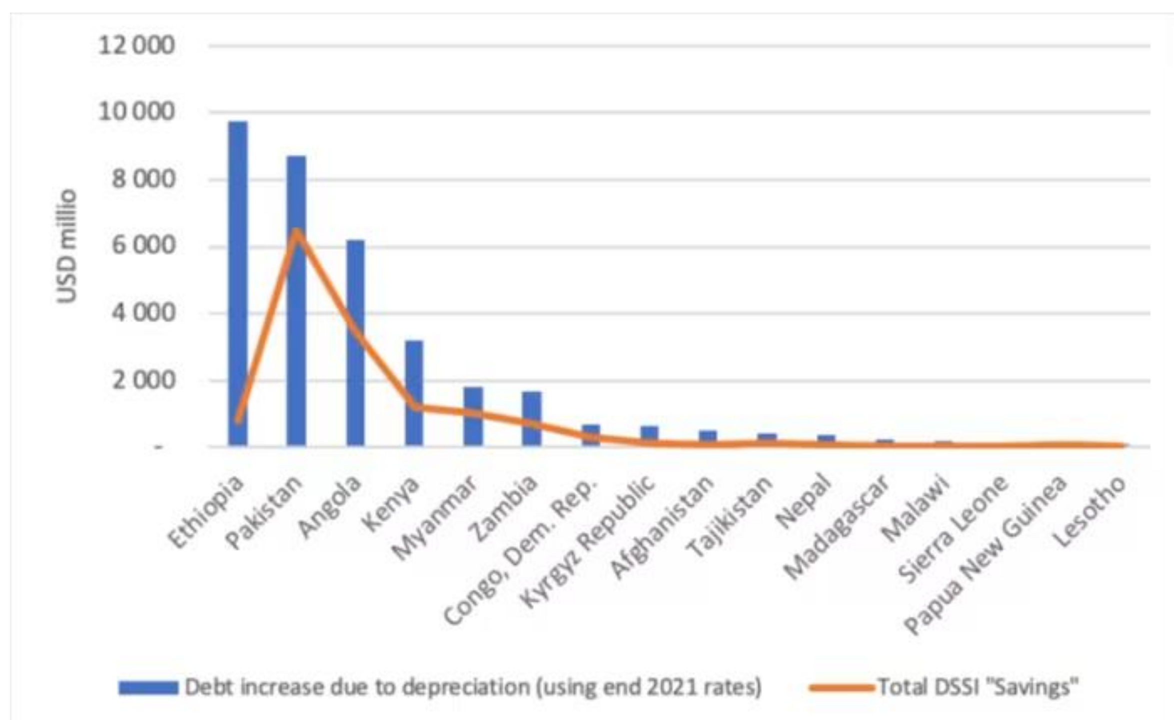
While many big developing countries have developed domestic bond markets — mitigating the risk of original sin — the foreign-currency share of the debts of low-income countries is around 70-85 per cent according to Unctad. When the currencies of developing countries fall — as they generally have against the dollar in recent years — the burden of these debts increases commensurately.

As the currencies of countries that participated in the DSSI depreciated 22.5 per cent on average against the US greenback, every dollar of debt suspended has now in practice turned into $1.225 of debt in local-currency terms. And it’s the local currency that is relevant for borrowers, given that the vast majority of their revenues will be domestic taxes. As a result, the non-participants had a better deal in debt terms.

Now, what does all this mean in practice? Let’s take Ethiopia, a good example as they were hit the hardest.

The country got a $800mn payment holiday, but the fall of the Ethiopian birr increased the effective burden of their debts by 35 per cent over 2020-22. In US dollar terms that is an increase of $9.7bn (conservatively recalculating using 2021 exchange rates).

Zambia got $700mn of relief, yet the depreciating kwacha led to a debt burden increase of $1.7bn. The effective weight of Kyrgyzstan’s debts grew by more than five times the amount suspended; $120mn versus $660mn.



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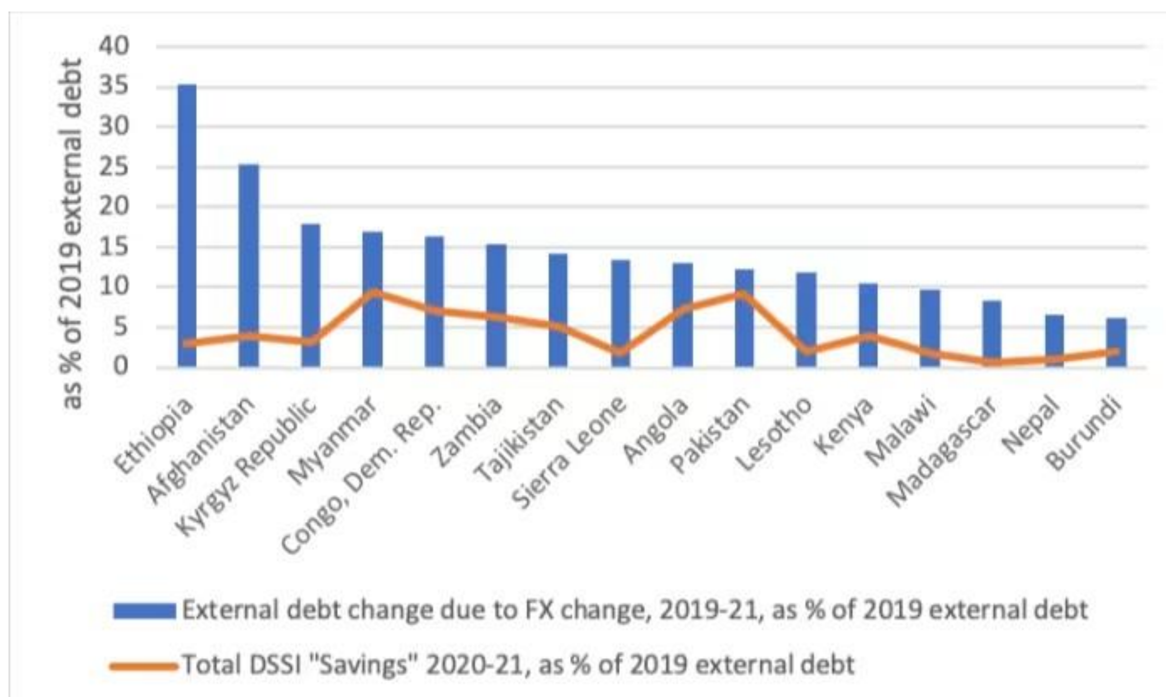
In relative terms, Ethiopia extended 2.9 per cent of its 2019 external debt against a de facto debt increase due to depreciation of 35 per cent. For the DRC Congo the tally was 7 per cent of debt extended, for a 16 per cent increase. In Zambia; 6.4 per cent extended, and a 15 per cent increase.



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Yes, the DSSI created $12.9bn in liquidity. But the currency effect increased their debt burden in domestic currency terms by a whopping $34bn by 2022. This is real local money that cannot be spent on healthcare or education.

Now, it is not the DSSI’s fault that many of these currencies have fallen in value. Developing country currencies as a group declined by a similar amount over the same time. One could argue that the DSSI beneficiaries would have been worse off without the debt suspension. But that’s not the point. The point is that significant currency risk in a country’s sovereign debt creates a debt doom loop.

Any adverse event — such as a war, pandemic or financial crisis — can lead to a flight to (dollar) quality and out of developing country assets. Their currencies then take a hit, their debt servicing costs shoot up, credit ratings are slashed, interest rates rocket and refinancing risks jump, leading to further capital flight, depreciations, and ultimately a potential sovereign default.

This dollar debt doom loop is active today. And it turns debt suspension into a senseless instrument that exchanges a big problem today for a much bigger problem tomorrow.

Almost a quarter of a century after identifying “original sin” as a major source of suffering, professors Barry Eichengreen Ricardo Haussmann and Ugo Panizza their earlier research in November 2022 in a paper fittingly titled *Yet It Endures: The Persistence of Original Sin*, which argued:

Notwithstanding announcements of progress, “international original sin” (the denomination of external debt in foreign currency) remains a persistent phenomenon in emerging markets. Although some middle-income countries have succeeded in developing markets in local-currency sovereign debt and attracting foreign investors, they continue to hedge their currency exposures through transactions with local pension funds and other resident investors. The result is to shift the locus of currency mismatches within emerging economies but not to eliminate them.

Preventing the debt doom loop can only be realised by de-risking dollar loans, removing the currency risk from borrowers (which will need to pay higher local interest rates in return). The World Bank already concluded in a document to raise funding for International Development Association member countries that:

Exchange rate risk in many IDA countries’ external public borrowing represents one of the biggest financial risks, and the potential impact is intensified by weakening debt sustainability.

The institution is committed for the first time in its history to do a pilot local currency loan from IDA resources in the coming year.

As official lenders have dumped currency risk on to their borrowers for the past 75 years, this is a hopeful development. But it too late to prevent the next debt crisis.

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