Making Development Bank Lending Safe for Poor Countries

By Barry Eichengreen and Ruurd Brouwer

AMSTERDAM – Global leaders will soon assemble in Paris for the Summit for a New Global Financial Pact, popularly known as the Macron Summit. According to Catherine Colonna, France's Minister for Europe and Foreign Affairs, the goal is to build a new financial contract between the Global North and Global South.

Among the summit's concrete objectives will be to enhance fragile economies' access to the finance needed to cope with higher food and energy prices, the green transition, and development challenges. A key issue is to ensure that this renewed financial access does not create more problems than it solves.

It is appropriate that the Macron Summit is in Paris, because France provides a cautionary tale in this respect. In 1947, when post-World War II France was still financially and economically vulnerable, it became the first country to receive a World Bank loan. The Bank awarded it $250 million "*pour faciliter la réparation des dommages causés par la guerre*."

Like today, a key purpose of the 1947 loan was to help the government meet France's energy requirements, which were critical for getting the economy back on its feet. Along with steel, fertilizer, and animal fats, the loan financed imports of seven million metric tons of coal and 1.2 million metric tons of petroleum products.

The 3.25% interest rate and 1% annual fee made the loan look like a bargain. The 4.25% cost to service the loan was far cheaper than market terms, and war-ravaged France would have had little chance of finding private capital at all. The loan came with a 30-year term, a five-year grace period, and minimal repayments in the first ten years, all in recognition of the French Treasury's limited resources and the country's difficult economic situation.

The conditionality attached to the loan also resembles current practice. The World Bank required proof that the proceeds were being used for approved purposes. Bank staff vetted supplier contracts, down to the level of individual invoices. France's chief negotiator considered this an affront to his country. But beggars couldn't be choosers.

That first World Bank loan continues to cast a long shadow over official thinking. Three quarters of a century later, the standard for multilateral development bank (MDB) loans remains 30 years with a ten-year grace period and concessional interest rates. Similarly, the focus of the Macron Summit is on supporting economic reconstruction and development by providing long-term, low-interest loans; the only additional requirement is that energy supplies should be green. *Plus ça change,* one might say.

There is also another unappreciated parallel. Like in 1947, the MDBs are still offloading their currency risk on the borrowers.

In 1950, a dollar cost 3.5 French francs; in 1958, when the franc was devalued, the exchange rate rose to 4.2 francs. In 1959 it rose above 4.9 francs, and another devaluation pushed it to nearly 5.2 in 1969. In all, the cost in francs of interest payments in dollars rose by 50%. The French government's annual payments rose even more sharply, because the initial grace period meant that it was now repaying the principal over 20, not 30, years.

This is the same problem faced by low-income countries today. Since the MDBs lend in dollars, poor countries are hammered when the dollar rises. And the hammer falls hardest on the poorest, because the grace period on their MDB loans concentrates their amortization payments in a shorter period. Thus, a capital increase for the MBDs and another round of concessional lending, as is likely to be proposed at the Macron Summit, will create more problems than it solves if the resulting loans are again denominated in dollars.

In some cases, the World Bank converts its dollar disbursals into local currency using swap transactions. But the Bank does not take currency risk on its balance sheet. It undertakes local currency conversions only when it can execute mirroring currency-swap transactions with market counterparties. And there are no such counterparties for the currencies of poor countries, given the illiquidity of their markets.

Rather than simply providing the World Bank with more capital or authorizing it to borrow to enable it to extend more dollar loans, shareholders meeting at the Macron Summit should create a guarantee fund to recapitalize the Bank in the event of exchange-rate-related losses. The Bank could then safely keep currency swaps and local currency loans on its balance sheet. In addition, leaders could agree to scale up mechanisms such as TCX (full disclosure: one of us is its CEO), designed to create access to indexed local currency for low-income sovereign borrowers.

These simple steps would eliminate the exchange-rate bugaboo that haunted France after WWII and which similarly stalks low-income countries today.

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