Key findings

Finance in Common

Local currency loans in the global development finance architecture

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We analyze how multilateral development banks (MDBs) can lend in local currency to investment projects that are "domestic-oriented" (DOIPs), i.e., which do not generate hard currency, without incurring in currency mismatches between their assets and liabilities, which would downgrade their credit ratings. The main policy recommendation is that MDBs be recapitalized by their owners and use the hard currency proceeds to buy local currency to be used for local currency denominated lending.

Objectives and research questions

The objective of this research project is to study the prospects of local currency denominated loans in the global development finance architecture. One of the main impediments for MDBs to lend in local currency is that they, in turn, fund themselves issuing hard currency denominated bonds in the international market. Thus, a currency mismatch between assets and liabilities increases the risks of MDBs, and may reduce their credit ratings, which increases their funding costs. Therefore, we are interested in identifying funding strategies that MDBs can follow in order to maximize their financing of investment projects in host countries with local currency denominated loans instead of USD denominated loans.

Methods

Regarding the methodology of this study, it is a theoretical analysis of the above-mentioned issues, following the "money view" theory of Mehrling (2011, 2012) and Schclarek, Xu and Yan (2022), and Schclarek and Xu (2022). Specifically, we model the different monetary transactions that are involved when an MDB is recapitalized with SDRs, an MDB opens a local bank account and buys local currency, an MDB grants a local currency loan to a local investment project, and a local investment project pays back the loan granted by the MDB.

Results

In order to allow local currency denominated loans by MDBs, one solution is that they issue local currency denominated bonds in the local bond markets, and use the local currency proceeds to lend. However, there are at least two problems with this financing solution: 1) local bond markets are usually small in less developed countries; and 2) this financing solution is not providing hard currency to finance imported supplies for the local investment projects. An alternative solution, and the one we think is better, is that MDBs be recapitalized, possibly with the SDRs that developed countries don't need. With these SDRs, MDBs can buy local currency from the local central bank and use the local currency to lend to investment projects. Note that this financing alternative imply that there is no currency mismatch because now MDBs´ assets are local currency denominated loans but they have no liabilities in hard currency. Furthermore, the host country receives hard currency, in exchange for the local currency, which it can use to buy imported supplies.

Recommendations

This research helps to improve the global development finance architecture and allows the involved players to maximize the financing of investment projects through local currency denominated loans. In this respect, it improves the successful fulfillment of the SDGs. MDBs should be recapitalized and use the proceeds to provide local currency denominated loans to local investment projects.

References

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