Key findings

Finance in Common

Exchange Rate and Balance of Payment Crisis Risks in the Global Development Finance Architecture

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We analyze exchange rate and balance of payment crisis constraints when multilateral development banks (MDBs) lend, in hard currency, to national development banks (NDBs), for NDBs to onlend to investment projects. Investment projects may be "export-enhancing" (EXIPs), which generate hard currency, or "domestic-oriented" (DOIPs), which do not generate hard currency. To increase the proportion of onlending to DOIPs, MDBs should increase their refinancing to NDBs. Furthermore, MDBs have to reduce the interest rate charged on NDBs. In addition, high return EXIPs need to be financed, and more locally-produced supplies, in contrast with imported supplies, should be fostered.

Objectives and research questions

The objective of this research paper is to analyze the exchange rate and balance of payment crisis risks that arise when an MDB finances itself in the international bond market to lend USD to an NDB for it to do on-lending to investment projects (IPs) in the NDB's country (host country). Investment projects maybe "export-enhancing" (EXIPs), which generate hard currency (for example, building a port or developing export agriculture), or "domestic-oriented" (DOIPs), which do not generate hard currency (for example, a solar farm or a sewage system).

Methods

Our paper is the first to formally analyze the cooperation between MDBs and NDBs and the impact of this cooperation upon the exchange rate and balance of payments crisis risks. Following the "money view" theory, we first make a theoretical analysis of the above-mentioned issues by modelling the different monetary transactions that are involved when an MDB funds itself in the international bond market in order to lend USD funds to an NDB, which onlends, in turn, in local currency to investment projects in the host country. Then we present a theoretical model where NDBs need to optimally choose the proportion of onlending that goes to EXIPs and DOIPs. We analyze three different scenarios depending on the availability of USD liquidity in the foreign exchange market of the developing country: the first case with abundant USD liquidity, the second case with normal USD liquidity, and the third case with scarce USD liquidity.

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Results

The main argument is that when the financing goes to export-enhancing investment projects in line with the comparative advantage of the host country, which improve the future current account balance, the exchange rate and balance of payment crisis risks are reduced for the different financial actors involved, but also for the financial system as a whole. By contrast, if the investment projects that are financed are domestic-oriented, the exchange rate and balance of payment crisis risks increase because DOIPs generate local currency proceeds and do not help increasing the supply of foreign exchange in the host country.

In the case with abundant USD liquidity, the NDB may freely choose the proportion of lending between the two types of investment projects, without any need to consider how this decision affects the foreign exchange market. In the scenario with normal USD liquidity, the NDB needs to consider how its decision affects the foreign exchange market, but does not need to worry about balance of payment problems. The NDB can lend a certain proportion to DOIPs, but has to lend a certain proportion to EXIPs, so as to increase in the future the supply of USD in the local foreign exchange market and avoid a large depreciation of the local currency. In the scenario with scarce USD liquidity, the NDB is bound by the foreign exchange market and balance of payment constraints. The NDB has to choose a higher proportion of EXIPs, and a lower proportion of DOIPs, than the cases with abundant and normal USD liquidity.

Recommendations

The COVID-19 pandemic and the war in Ukraine correspond to situations where the USD liquidity scenario passes from an abundant or normal scenario to one of scarce USD liquidity. Thus, in order to minimize the adverse effects of the pandemic, it is necessary that MDBs reduce the interest rate that they charge NDBs. Further, it is necessary that MDBs refinances NDBs and give them more time to pay back loans.

In order to increase the chances that the host economy would not suffer from the scarce USD liquidity, it is important that domestic policies are enacted so that the domestic monetary and financial conditions are more stable. From an international perspective, it is also important that the Global Financial Cycle and the Global Trade and Commodity Cycle are more stable. If the accelerating RMB internationalization fosters more stable cycles, this may be a positive feature for the host country in making a more flexible decision about the proportion of DOIPs and EXIPs when receiving on-lending from MDBs.

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