FT FINANCIAL TIMES

This op-ed was published in the FT Alphaville edition of April 13.

It’s the currency, stupid (part 2): is the lowest hanging fruit forbidden?

A billions-to-trillions blind spot

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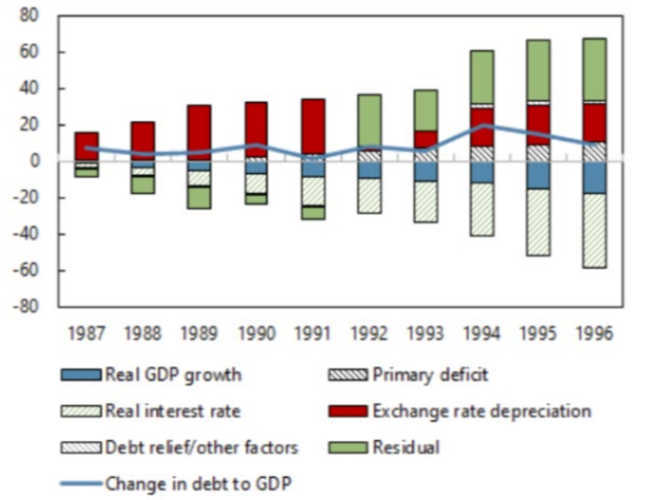
As part of their Annual Meeting, World Bank and IMF treat observers to a wealth of data, analyses and projections. The focus is on climate finance, debt sustainability of Low Income Countries (LICs) and, preferably, some combination of the two. But countries in debt distress tend not to borrow to invest in green infrastructure — so debt’s the horse, climate the cart.

A new IMF working paper with the catchy title ‘[Are We Heading for Another Debt Crisis in Low Income Countries?]’ compared debt vulnerabilities in the pre-[Heavily Indebted Poor Countries Initiative] mid-90s with those of today.

Figure 9. Decomposition of Debt Drivers

A. Drivers of Debt Dynamics in LICs 1987-96
(cumulative change in percentage points of GDP)



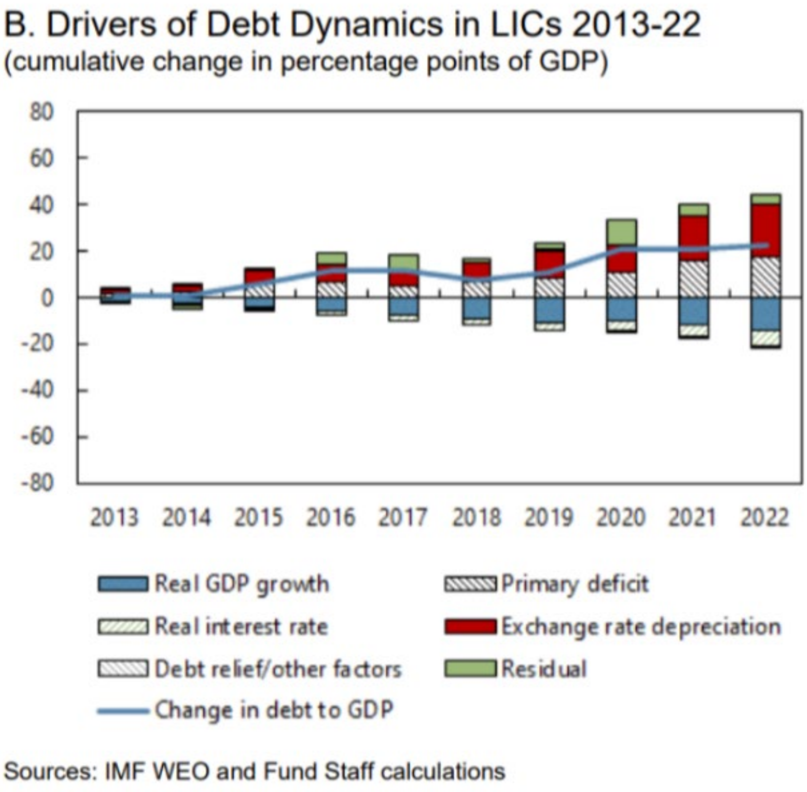
Sources: IMF WEO and Fund Staff calculations

One conclusion is that the world of debt restructurings has become more complex. There are more players, less transparency, more complicated instruments and the Chinese don't speak debt forgiveness. A combination of factors that made Robin describe the bankruptcy process for countries as "a shitshow".

So, debt resolutions suck — and should be prevented to skip the shitshow. The paper offers some hope:

Primary deficits and valuation effects from exchange rate depreciations remain the two most dominant upward drivers of debt accumulation in LICs

The two key variables that drove debt upward late last century are government deficits and currency risk. The 2013-2022 analysis confirms this; in this period too exchange rate depreciation and primary deficits define upward debt dynamics.

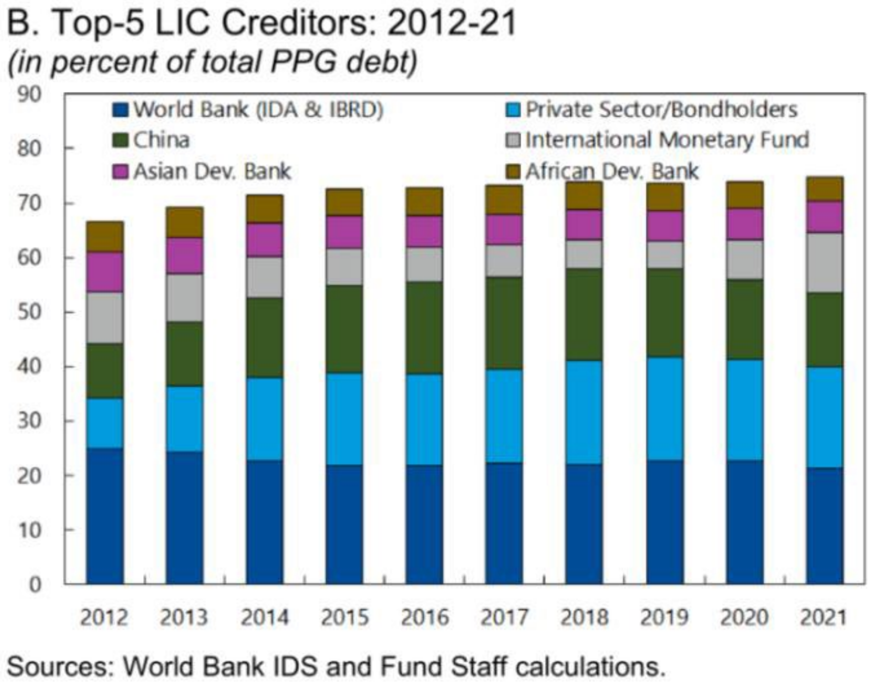


So, this is good news, right? The variables are identified. The next question is who can directly influence these variables.

In the case of government budget deficits that's not obvious, as it involves multilateral negotiations, political processes, elections and diplomatic wheeling and dealing. The influence that can be exerted by lenders is, at best, indirect.

In the case of currency risk, it is much more straightforward. Currency risk is directly related to the loan product offered by the lender, and accepted by the borrower.

That brings the second bit of good news. Although China and private bond holders have grown substantial, multilaterals and the IMF are still the most important lenders to LICs, so it lies within their power to offer a loan product that mitigates currency risk. It would befit the World Bank, which transacted the first ever cross currency swap in 1981.



Exchange rate risk was a key factor in the Asian debt crisis, the LatAm debt crisis and many if not most EM crises. Given the Bretton Woods institutions' leading role in lending to and advising the poorest countries, the last step is to assess what lessons they've learned from doing so.

The independent evaluation group studied "World Bank Support for Public Financial and Debt Management in IDA-Eligible Countries", evaluating over US$25bn in support over 1,500 activities during 10 years. Despite the focus on public sector debt management, the evaluation mentions the word 'currency' once, in Appendix G on page 160. There, a table describes the government of Ghana's target for currency and interest rate risk management. Yes, Ghana is in default.

In late 2021, another evaluation from the independent evaluation group saw the light, requested by donors "to help IDA-eligible countries achieve and maintain debt sustainability by incentivizing their move toward transparent, sustainable financing".

The topic was the World Bank's Sustainable Development Finance Policy and it had a strong focus on debt sustainability. Yet, the C-word is mentioned just three times in over 150 pages. Twice in a footnote and once in a case study on Papua New Guinea. Never in relation to risk or debt sustainability.

The two evaluations and the IMF working paper are no exception. Currency risk is the most unpredictable and largest driver of upward debt dynamics, but has not been identified by the World Bank/IMF as a problem worth solving.

Regardless of the upcoming choice between climate finance or debt sustainability, this billion-dollar blind spot should be tackled before it turns into a trillion-dollar debt crisis. This could well be some (scarce) low-hanging fruit for the World Bank's new president.