Key findings

Exchange rate and balance of payment risks in the Global Development Finance architecture

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THE VISIBLE HAND: Development Banks in Transition

This paper analyzes the exchange rate and balance of payment crisis risks when Multilateral Development Banks lend, in hard currency, to National Development Banks (NDBs), for them to onlend to investment projects. Investment projects may be "export-enhancing" (EXIPs), which generate hard currency, for example building a port or developing export agriculture. Or they can be "domestic-oriented" (DOIPs), which don't generate hard currency, for example building a solar farm or a sewage system. If Multilateral Development Banks want to increase the proportion of onlending to DOIPs, they need to increase their refinancing to NDBs, and allow more time to pay back the loans. Further, they need to reduce the interest rate charged on NDBs.

Objectives and research questions

In recent times there has been a renewed interest in the idea of collaboration between Multilateral Development Banks (MDBs) and National Development Banks (NDBs), through on-lending arrangements, as a tool for economic growth and development in developing countries. Unfortunately, the access to hard currency by National Development Banks (NDBs) through MDBs loans not only generates exchange rate and balance of payment crisis risks for the particular financial actors involved, but also for the financial system as a whole. It is important to note that hard currency is needed to pay back the loan from the MDB to the NDB.

Thus, this paper analyzes these risks when MDBs lend, in hard currency, to NDBs, for them to onlend to investment projects. Investment projects may be "export-enhancing" (EXIPs), which generate hard currency, or "domestic-oriented" (DOIPs), which do not.

Methods

The authors present a theoretical model where NDBs need to optimally choose the proportion of onlending that goes to export-enhancing investment projects, and domestic-oriented investment projects. They analyze three different scenarios depending on the availability of USD liquidity in the foreign exchange market of the developing country: a first case with abundant USD liquidity, a second case with normal USD liquidity, and a third case with scarce USD liquidity.

Results

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 his 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, to increase in 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. Now, the NDB has to choose a higher proportion of EXIPs and a lower proportion of DOIPs, than in the cases with abundant and normal USD liquidity.

Recommendations

- It is important that both national development banks and multilateral development banks **consider foreign exchange and balance of payment constraints when choosing what types of investment projects to finance.**
- If MDBs want to increase the proportion of onlending that goes to “domestic-oriented” investment projects (DOIPs), they also need to **increase their refinancing to NDBs, and give them more time to pay back their loans.**
- Further, it is important that MDBs **reduce the interest rate that they charge NDBs.**
- In the current Covid pandemic, where the availability of USD liquidity has deteriorated for developing countries, it is key to increase **the MDBs’ refinancing to NDBs and lower the interest rate charged.**

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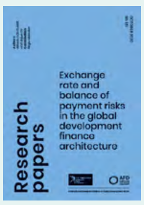

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