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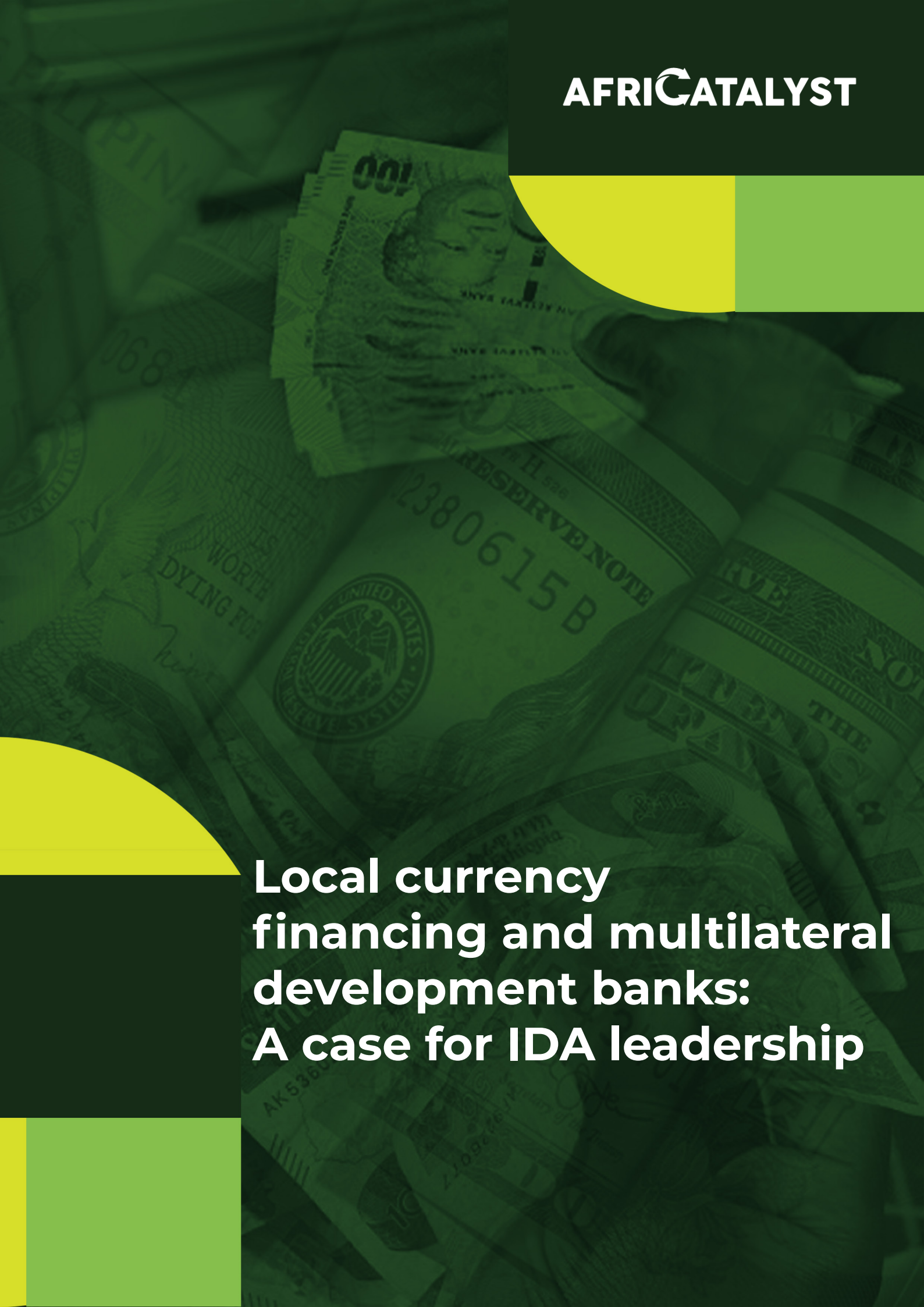

Local currency financing and multilateral development banks: A case for IDA leadership

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Research Paper on

Local Currency Financing and Multilateral Development Banks[1]

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Abstract

Most low-income countries accumulate debt in currencies other than their local currency. This is both a blessing and an "original sin." While foreign currency-denominated loans provide a valuable source of hard currency, they also create repayment risks and have been linked to rising debt burdens. Can multilateral development banks (MDBs), one of the largest creditors to the world's poorest countries, help their low-income clients manage these risks? In this paper, we examine this original sin, particularly among sub-Saharan African countries. Using an illustrative case from Ethiopia, we show that decreasing exchange rates increases the local currency value of most debt owed to external lenders. Since most low-income countries service their debt using government revenues earned in their local currency, this negatively impacts the overall debt burden. We argue that MDBs can offer an immediate-term solution: sovereign local currency loan offerings. Focusing on the special case of the World Bank's International Development Association (IDA), we evaluate the challenges and opportunities associated with local currency financing as a multilateral initiative. Our conclusions emphasize the need for IDA to play a leading role in this initiative, helping low-income economies avoid worsening debt positions.

1. Introduction

In 2023, seven African countries were classified as being in debt distress (IMF, 2024). According to the International Monetary Fund (IMF) and the World Bank, an additional thirteen countries were at high risk of falling into debt distress. With government interest payments more than doubling since the early 2010s, it was unsurprising when Ethiopia followed in the footsteps of Ghana and Zambia by defaulting on its debt (Fitch, 2023).

In response to this mounting crisis, the international community rallied to find debt management solutions. Some creditors signaled a willingness to engage in debt restructuring, but they often required an IMF bailout as a precondition (Do Rosario, 2024). However, one of the IMF's conditions for assistance—a currency devaluation—has proven to be a significant hurdle. Governments in many low-income countries are concerned about the impact of devaluation on the local currency's value, particularly in relation to their growing foreign currency-denominated debts (Nation, 2023).

These concerns are valid. Low-income countries frequently borrow from multilateral, bilateral, and private creditors in hard currencies such as the US dollar and the Euro. For instance, the World Bank's International Development Association (IDA) currently holds the largest share of Ethiopia's external debt, and it seldom lends to governments in their local currencies (Ministry of Finance, Ethiopia, 2023a).

In fact, over the past five years, approximately half of Ethiopia's external debt has been denominated in US dollars (Ministry of Finance, Ethiopia, 2023b:4). While such loans provide a valuable source of foreign currency, they also expose countries like Ethiopia to significant risks.

One major risk arises from the mismatch between the local currency in which government revenues are collected and the foreign currencies in which debt repayments must be made. This disparity often leads to rising debt burdens and, in extreme cases, default, particularly when currency depreciation is factored in. For these countries, their ability to repay loans often hinges on the value of their GDP in US dollar terms, making any real exchange rate fluctuations potentially destabilizing for debt sustainability (Bacchiocchi and Missale, 2015: 307).

Addressing this problem through more local currency borrowing from external creditors could alleviate the burden, but low-income countries (LICs) have historically faced difficulties borrowing in their own currencies, a challenge known as "original sin" (Eichengreen and Hausmann, 1999). As a result, LICs are left with significant repayment risks arising from currency mismatches.

Can multilateral development banks (MDBs) help LICs manage these risks?

In this paper, we explore the issue of "original sin" using Ethiopia as a case study. We demonstrate how currency depreciation has exacerbated the local currency value of foreign currency-denominated sovereign debt owed to MDBs like the World Bank, thereby increasing Ethiopia's debt burden. We argue that expanding the use of local currency loans by MDBs, particularly to sovereign borrowers in LICs, could help mitigate the risks posed by currency mismatches and improve debt sustainability.

Based on reports from MDBs, the IMF, governments, stakeholder interviews, and existing research on "original sin," we present three key findings to inform our policy recommendations.

- **First, the accumulation of foreign currency-denominated debt is a significant problem for LICs, though less so for emerging market economies. The latter have developed deep local currency bond markets that allow them to borrow from abroad in their own currencies (Du et al., 2020; Arslanalp and Tsuda, 2014). For most LICs, however, such markets remain underdeveloped.**

- **Second, the underdevelopment of local currency bond markets limits the short-term options available to external actors like MDBs. While currency hedging solutions exist that could facilitate the development of local capital markets in LICs (Kapoor et al., 2021), World Bank Group President Ajay Banga has acknowledged that these solutions are medium- to long-term measures, leaving the short-term outlook uncertain (World Economic Forum, 2024).**

- **Finally, we observe that current initiatives by MDBs to scale up local currency financing are predominantly focused on non-sovereign (private sector) lending operations, rather than on sovereign loans. While LICs face risks associated with foreign currency-denominated debt, MDBs have been reluctant to bear the risks of scaling up local currency lending to governments.**

Our argument calls for MDBs to shift their portfolios towards more local currency loans, while acknowledging the risks this entails. Potential avenues for mitigating these risks include offering loans on a project-by-project basis, creating liquidity pools, and engaging in cross-currency swaps. The public policy mandate to support LICs' development aspirations should compel MDBs to assume more of the currency risk, as these countries already have limited capacity to manage it.

We provide several policy recommendations, focusing specifically on the role of IDA, one of the largest multilateral lenders to LICs. Given its size and influence, IDA is well-positioned to lead the way in offering sovereign local currency loans. Such loans, coupled with IDA's preferential terms, could make debt servicing more manageable and predictable for LICs.

Our selection of IDA as the focal point of this analysis is based on four factors: the low-income profile of its borrowers, its financing model, the affordability of its loans, and its extensive involvement in capacity-building at the country level.

This final factor is particularly important, as it addresses demand-side concerns related to local currency loans and highlights the need for additional technical assistance to enhance debt management in LICs. While IDA should provide local currency loans, LIC governments must also create the regulatory conditions necessary for effective asset-liability management by MDBs.

The remainder of the paper is structured as follows:

Section 2 provides an overview of the foreign currency-denominated debt problem in LICs.

Section 3 examines how currency depreciation, a widespread trend in sub-Saharan Africa, exacerbates this issue.

Section 4 explores the challenges and opportunities of local currency lending to LICs.

Section 5 assesses IDA's potential role in sovereign local currency financing. The final section presents our policy recommendations, specifically tailored to IDA.

2. Debt denomination and original sin

Governments routinely face critical decisions regarding borrowing. For low- and middle-income countries, borrowing from domestic markets or foreign creditors, such as multilateral development banks (MDBs) or bond market investors (where possible), is necessary to finance development. With low per capita income and high expenditure pressures, sovereign debt becomes an essential tool. The decisions made by ministries and debt management offices—how much to borrow, through which instruments (loans or bonds), and under what terms—carry significant implications for long-term debt sustainability. However, these choices are far from straightforward.

One of the most important decisions for sovereign borrowing is the denomination of debt, either in domestic or foreign currency (Ballard-Rosa, Mosley, and Wellhausen, 2022). Unfortunately, many governments do not have a real choice in this matter. The poorest and smallest countries are at a disadvantage because international investors are often unwilling to lend in local currencies. Even MDBs and development finance institutions of major donors favor US dollar-denominated loans over local currency options for developing countries (Kapoor et al., 2021: 2).

This phenomenon has been termed the "original sin," a reference to the inability of developing countries to borrow long-term in domestic currency, except at ultra-short maturities, and their inability to borrow in local currency from international markets (Eichengreen and Hausmann, 1999; Eichengreen, Panizza, and Hausmann, 2003; 2005; 2007; 2022; Khan, 2005). The first aspect of original sin introduces the risk of maturity mismatches, as short-term domestic currency debt often carries volatile interest rates (Eichengreen, Hausmann, and Panizza, 2002: 17). Financing long-term projects with short-term loans can lead to repayment challenges, particularly when interest rates rise and government revenues are low.

Despite the risks of short-term debt, the second dimension of original sin—reliance on foreign currency-denominated loans—has proven more concerning (Eichengreen and Hausmann, 2005). While foreign currency debt is not inherently detrimental, developing countries often prefer these loans from MDBs because they carry lower interest rates and longer maturities, making them cheaper than other options (Sarkodie, 2022; Gutierrez et al., 2023). Additionally, they provide much-needed hard currency. However, the "sin" lies in the difficulty of escaping this reliance, which can lead to significant consequences.

Several factors influence the occurrence and magnitude of original sin. The literature points to country size and structural problems in international markets, such as network externalities and transaction costs, as critical factors—most of which are beyond the control of smaller developing nations (Eichengreen and Hausmann, 1999; Eichengreen, Hausmann, and Panizza, 2002; Hausman and Panizza, 2003). For creditors, smaller, low-income countries are often seen as too risky for long-term domestic currency borrowing due to imperfections in global capital markets (Du and Schreger, 2016; Mosley and Rosendorff, 2023). Other scholars have highlighted global economic conditions (Arslanalp et al., 2020; Romero et al., 2021) and the liquidity preferences of investors (Gegenfurtner, 2021) as factors that shape the ability of developing countries to borrow in local currencies.

Additionally, country-specific factors play a role. Ogrokhina and Rodriguez (2018) suggest that while the structure of international financial markets matters, domestic monetary policy, particularly inflation targeting, can affect a country's foreign currency debt levels. Similarly, Hale et al. (2020) argue that global financial conditions and a country's inflation history impact its ability to issue local currency debt. Others, like Ottonello and Perez (2019), Bassetto and Galli (2019), and Aizenman and Zheng (2023), emphasize the influence of inflation risk, while Engel and Park (2022) point to the role of monetary policy credibility in determining foreign currency borrowing. Exchange rate volatility, closely linked to monetary policy, also affects foreign currency debt issuance (Lee, 2022).

Empirical evidence suggests that countries with less credible monetary policies are more likely to incur foreign currency debt as a substitute for that credibility. Claessens et al. (2007) find that the depth of domestic financial systems and the flexibility of exchange rate regimes play a role in foreign currency issuance. Political ideology may also matter: right-leaning governments are more likely to opt for foreign currency denomination to mitigate currency risk and reduce borrowing costs, while left-leaning governments prefer local currency denomination, which offers greater monetary policy flexibility (Ballard-Rosa, Mosley, and Wellhausen, 2022). Han (2024) notes that the dissipation of original sin is associated with the development of local capital markets in emerging economies

Despite stable political environments, credible economic policies, and sound monetary and financial histories, many developing countries still struggle to borrow in their local currencies (Eichengreen et al., 2005; 2007; 2022). This leaves them with two unappealing options: short-term, high-cost local currency debt or long-term, lower-cost foreign currency debt, which carries significant risks.

Long-term trends in the currency composition of public debt in developing countries reveal the dominance of foreign currency-denominated debt. Most external debt is issued in the currencies of major financial centers, such as the US dollar, Japanese yen, British pound, Swiss franc, and Euro. Since 2015, the US dollar and Euro have accounted for over 98% of all foreign currency-denominated debt issued by emerging markets and developing economies (OECD, 2023: 105). This inability to issue long-maturity local currency debt, combined with the overwhelming concentration of foreign currency-denominated debt, creates multiple challenges for developing countries.

The growing issuance of Eurobonds by African countries has amplified the influence of sovereign credit ratings and international rating agencies such as Moody's, Fitch, and S&P. African countries often have little control over how they are rated, and a recent report from the United Nations Development Programme (2023) suggests that these ratings are highly subjective.

This subjectivity, shaped more by methodological peculiarities than macroeconomic fundamentals, explains why African countries face some of the highest borrowing costs globally, with excess interest payments amounting to over $24 billion (Gilpin et al., 2024)[2].

The most significant challenge, however, stems from the financial disruptions caused by foreign currency-denominated debt. Having a large stock of such debt risks creating currency mismatches on a country's balance sheet. This occurs when the external debt obligations in foreign currency do not align with government revenues, which are primarily denominated in local currency (Eichengreen, Hausmann, and Panizza, 2005: 13).

Theoretical and empirical evidence indicates that these currency mismatches increase the probability of macroeconomic instability and financial crises, including sovereign defaults. Korinek (2011) demonstrates that foreign currency debt heightens macroeconomic volatility and increases risk premia on emerging markets. Gumus (2013) similarly finds that default risk decreases as domestic currency borrowing rises, though the effect of debt denomination on default risk varies with output levels.

Empirically, foreign currency debt is linked to greater volatility in real output, capital flows, and exchange rate management, often due to the "fear of floating" (Eichengreen, Hausmann, and Panizza, 2005: 13; 2022)[3]. Moreover, foreign currency-denominated debt hampers growth and impedes the development of local bond markets (Fritz and Metzger, 2006: 5; Eichengreen and Hausmann, 1999: 7; OECD, 2023).

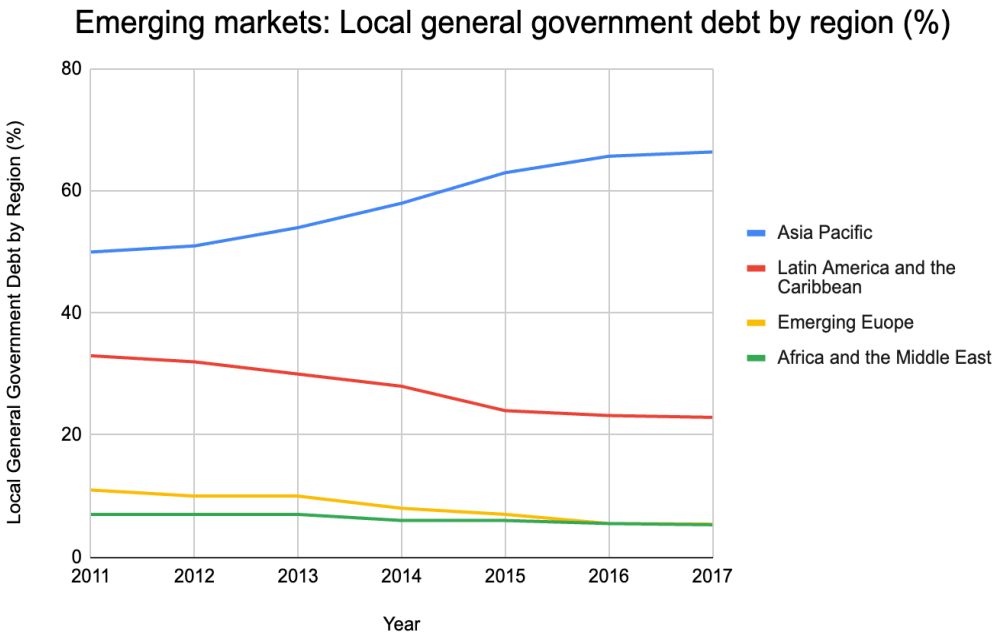
2. Several organizations, like UNDP, Brookings Institution, AfriCatalyst, and the African Union's African Peer Review Mechanism (APRM), have called for more transparency from international credit rating agencies.
3. Elchengreen, Hausmann, and Panizza (2005, 2022) capture original sin by (one minus) the percentage of international bonds and cross-border loans that are denominated in local or domestic currency.

2.1 Cause for optimism? Low versus middle-income countries

Recent empirical evidence suggests that original sin has become less prevalent over the past two decades, particularly in emerging market economies (EMEs) (Han, Lee, and Oh, 2023). However, there is less reason for optimism for lower-income countries (Ogrokhina and Rodriguez, 2018; Eichengreen et al., 2023; Fujii, 2024). Original sin remains a persistent issue for the world's poorest countries, and claims about its dissipation largely stem from the development of local currency bond markets (LCBMs) in EMEs. These countries, which are primarily upper-middle-income, have access to international financial markets and are frequently included in leading emerging market bond indices (Eichengreen, Hausmann, and Panizza, 2022: 5).

Following the 2008 global financial crisis, the expansion of global liquidity and the emergence of more risk-tolerant investors allowed EMEs to borrow long-term, at fixed rates, in their domestic currencies (Arslanalp and Tsuda, 2014; Du and Schreger, 2016; Carstens and Shin, 2019; Hofmann et al., 2020; 2021; Shin and Von Peter, 2022; Ballard-Rosa, Mosley, and Wellhausen, 2021; Han, Lee, and Oh, 2023). By the late 2010s, the share of emerging market debt issued in local currencies approached 90 percent (IMF, 2018: 1). From 2003 to 2017, the proportion of external sovereign debt issued in local currencies by EMEs—including Brazil, South Africa, Indonesia, and Türkiye—rose from 20 percent to 60 percent (Du and Schreger, 2016: 4594). The OECD further reports that the share of foreign currency-denominated debt issuances for EMEs continued to decline post-2020, dropping from 7% in 2021 to 4% in 2022 (OECD, 2023: 98). This positive trend, however, has not extended to LICs. Little progress has been made in overcoming original sin in low-income countries, particularly in sub-Saharan Africa. As Figure 1 illustrates, the development of LCBMs in EMEs during the expansion period was largely concentrated in the Asia-Pacific region (IMF, 2017: 6). Although some sub-Saharan African countries are beginning to develop their LCBMs (Adelegan and Radzewicz-Bak, 2009; Berensmann, Dafe, and Volz, 2015; Essers et al., 2016; Mu, Phelps, and Stotsky, 2013), the immediate prospects remain discouraging. Few countries in the region possess the market size necessary for significant LCBM development, with South Africa often being the sole representation from sub-Saharan Africa in analyses of original sin dissipation (Eichengreen, Hausmann, and Panizza, 2022: 35). South Africa's large financial sector and well-developed LCBM set it apart, leaving the smaller markets in other countries as a major impediment to further LCBM growth.

Figure 1: Local debt for emerging market countries



Source: IMF (2018)

The least developed sub-Saharan African economies face even greater challenges in overcoming original sin. Most of these countries suffer from limited domestic savings, low market liquidity, and weaker institutional quality. Combined with smaller market sizes and heightened political risks, these factors make it less attractive for international investors to absorb the fixed costs required to enter such markets. Moreover, the marginal benefit of adding additional currencies to a portfolio diminishes over time, further discouraging investment (Eichengreen, Hausmann, and Panizza, 2022: 35)[4].

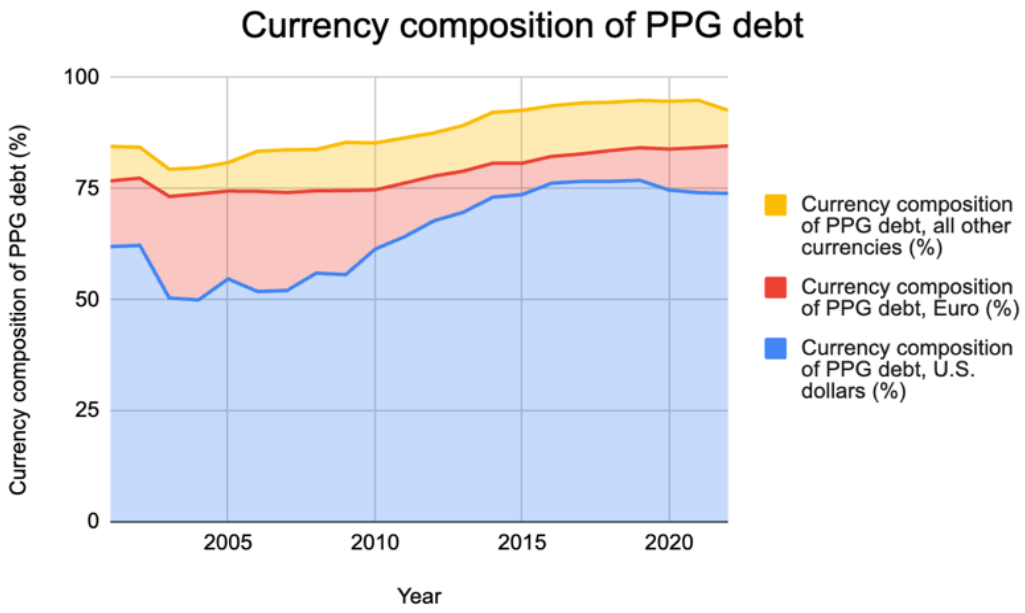
Some scholars have proposed that South-South monetary coordination projects could help eliminate original sin (Fritz and Metzger, 2006). However, even when sub-Saharan African countries participate in such economic integration schemes, the problem persists (Peist, 2023). Regional cooperation and integration initiatives, such as the CFA Franc zone, still lack the necessary scale to fully overcome original sin (Panizza, 2006: 34). As a result, despite the optimism in both academic and policy circles, no significant shift has occurred in the sub-Saharan African context that would meaningfully alleviate concerns about the original sin dilemma.

4. As Khan (2005: 71) argues, "because of the declining marginal benefits of portfolio diversification, it does not follow that the characteristics that allowed a few small countries (including South Africa) to issue external debt in their own currencies, should allow us to conclude that acquiring those characteristics would be sufficient to allow others to achieve the same results."

2.2 Sub-Saharan Africa in focus

Trends in sub-Saharan Africa reveal an overwhelming dependence on foreign-currency denominated debt. As shown in Figure 2, the percentage of external long-term public and publicly guaranteed debt by currency composition across low-income sub-Saharan African countries indicates a significant reliance on US dollar-denominated debt. Since 2005, the proportion of dollar-denominated debt has risen substantially, further deepening these countries' exposure to foreign exchange risks.

Figure 2: Sub-Saharan Africa (excluding high income)



Source: World Bank International Debt Statistics (IDS)

We follow Fujii's (2024) approach and assume that the "all other currencies" category from the International Debt Statistics (IDS) in Figure 2 includes debt denominated in borrowers' domestic currencies. Figure 2 illustrates that the share of publicly guaranteed (PPG) debt in local currencies has been significantly lower than foreign currency-denominated debt. However, the actual amount of local currency-denominated debt may be even smaller than this category suggests. This is because many African countries issue debt in currencies that are neither their local currency nor one of the main currencies listed in the IDS (Eichengreen, Hausmann, and Panizza, 2022: 11). For instance, several Southern African countries borrow in South African Rand and Chinese Renminbi. In Malawi, the government's 2018 medium-term review strategy revealed that 15% of its total external debt was denominated in Chinese Renminbi (Ministry of Finance Malawi, 2018). The inclusion of such currencies in the "other currencies" category implies that the extent of original sin may be more severe than Figure 2 suggests.

The concentration of dollar-denominated debt is unsurprising, given that many African countries have traditionally relied on concessional external borrowing in foreign currencies to meet their financing needs (Essers and Cassimon, 2012). Much of this borrowing is sourced from multilateral development banks (MDBs), such as the World Bank and the African Development Bank (AfDB), which predominantly lend in foreign rather than local currencies.

Some scholars argue that currency mismatches played a significant role in the creation of the IMF and World Bank-led Heavily Indebted Poor Countries (HIPC) initiative (Chuku et al., 2023). Launched in 1996, the initiative aimed to provide debt relief to eligible countries, primarily African, to make their debt burdens more sustainable. According to Chuku et al. (2023: 31-32), the currency mismatches that triggered the consequences of original sin—including slow growth, capital flow volatility, and exchange rate depreciations—were key drivers behind the establishment of the HIPC initiative.

By the end of 1995, the debt portfolios of many HIPC participants—84% of which were African—featured large proportions of foreign currency-denominated debt, approaching 95%. These portfolios also included segmented currencies with no direct links to export revenues (Chuku et al., 2023: 31-32). For example, while Zambia held some dollar-denominated debt, its export revenues, particularly from copper trading, were tied to other regions, such as the European Union. The mismatches between government revenues and external debt obligations meant that traditional debt mechanisms were insufficient to restore debt sustainability for heavily indebted poor countries in the 1990s (Chuku et al., 2023: 30-32). Furthermore, falling commodity prices and exchange rate depreciation against the US dollar significantly amplified debt burdens, resulting in slow growth. These conditions—marked by high levels of foreign currency-denominated debt and persistent currency depreciation—have long placed African countries in a vulnerable position.

3. Debt and depreciation: An unholy alliance

Several empirical studies have shown that when a large currency depreciation interacts with significant foreign currency-denominated debt (and liability dollarization, in particular), it can lead to financial crises fueled by the rising local cost of debt servicing and equally rising debt-to-GDP ratios (Panizza and Taddei, 2020). It can also lead to a significant fall in credit worthiness as well as corresponding declines in spending and output (Disyatat, 2001; Mishra, Gupta, and Sahay, 2003; Goldstein and Turner, 2004: 15). Put differently, the simultaneous presence of depreciation and a large stock of foreign currency-denominated debt often has negative impacts for macroeconomic stability and debt sustainability. Several empirical studies have shown that when a large currency depreciation interacts with significant foreign currency-denominated debt (and liability dollarization, in particular), it can lead to financial crises fueled by the rising local cost of debt servicing and equally rising debt-to-GDP ratios (Panizza and Taddei, 2020). It can also lead to a significant fall in credit worthiness as well as corresponding declines in spending and output (Disyatat, 2001; Mishra, Gupta, and Sahay, 2003; Goldstein and Turner, 2004: 15). Put differently, the simultaneous presence of depreciation and a large stock of foreign currency-denominated debt often has negative impacts for macroeconomic stability and debt sustainability. Many LICs, especially in sub-Saharan Africa, have experienced currency depreciations and increasing debt servicing burdens in local currency terms. Where debt is predominantly denominated in foreign currency, even debt restructuring efforts under these conditions are likely to offer only temporary solutions to a problem that is likely to resurface quickly. The debt portfolio and exchange rate problems of many HIPC participants, like Zambia, remain similar even after the HIPC initiative's launch nearly three decades ago. Figure 3 shows how the nominal value of one US dollar (USD) relative to a select number of local currencies in Africa has changed over time (1957-2022). A decrease indicates an appreciation of the currency against the US dollar, while an increase indicates currency depreciation.

Across different countries in Africa, local currencies have generally depreciated against the US dollar. This applies to major economies, like Nigeria and South Africa, as well as countries currently in debt distress, like Zambia and Ghana. It also applies to the member states of the CFA Franc Zone in West and Central Africa.

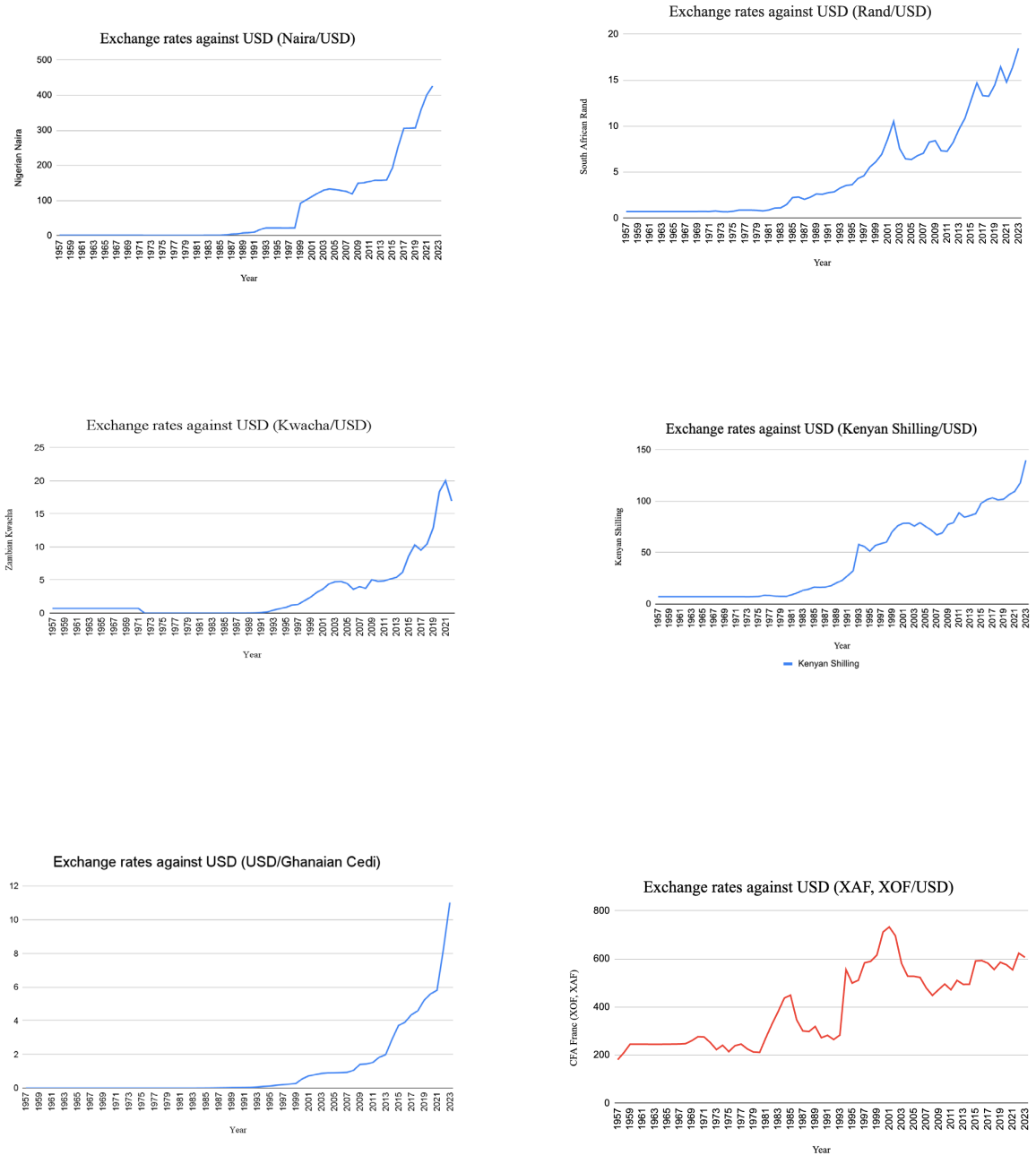
Given that a sizeable portion of the public debt in sub-Saharan Africa is dollar denominated, the fall in local currency values against the US dollar means that the burden of foreign currency debt continues to increase. According to the IMF (2023b: 3), currency depreciations increased public debt in the region by up to 10 percentage points between 2020 and 2022. The increase has been far more pronounced for economies which are in non-pegged currency regimes precisely because a large share of their debt is either dollar-denominated or Euro-denominated compared to economies with pegged currencies.

The negative impacts on increasing public debt are not just limited to worsening public deficit, but also extend to the draining of official reserves, especially to finance those debts (Onen, Shin and von Peter, 2023: 27). Worryingly, even with more recent multilateral efforts to help developing countries manage their debt more sustainability, like the Debt Service Suspension Initiative (DSSI), the combination of foreign-currency denominated debt and falling exchange rates may place an even greater burden on developing countries. This is especially true for those countries either in or at high risk of debt [5]

5. About one-third of the countries in sub-Saharan Africa are either in or at high risk of debt distress, including many countries that benefited from debt relief in the 1990s (Coulibaly, Gandhi, and Senbet, 2019).

In the following section, we analyze the impact of exchange rate depreciation on external debt by offering a brief illustrative example. By considering the experience of Ethiopia, we seek to fulfil a modest objective: to demonstrate the plausibility of consequences implied by the original sin logic in the real world.

Figure 3: Exchange rates with the US Dollar



Source: Bank for International Settlements

3.1 The case of Ethiopia: Original sin amidst debt suspension

The case of Ethiopia is particularly noteworthy due to its recent default episode and currency reform. In July 2024, the Central Bank allowed the local currency, the Birr, to trade freely—a reform implemented as part of efforts to secure more than $10 billion in debt relief and IMF funding. This policy action had previously sparked concerns among authorities about its po-tential impact on the country's substantial foreign currency-denominated debt in terms of local currency (Savage and Endeshaw, 2024). More than half of Ethiopia's government debt is held by external creditors, making it highly vulnerable to sharp exchange rate depreciations.

Government reports from Ethiopia's Ministry of Finance indicate that the government has successfully suspended part of its external debt service to bilateral creditors, amounting to USD 216 million (Ethiopian Ministry of Finance, 2023a; 2023b: 6). This relief stems directly from the DSSI, an initiative launched by the G20 to allow developing countries to redirect resources towards combating the global pandemic instead of servicing debt. Ethiopia, like several other African nations, has participated in the DSSI since its inception in 2020, enjoying temporary payment relief (see Table 1).

However, even when countries receive payment holidays and debt relief, concurrent depreciation of their domestic currencies can quickly inflate their debt burdens. By July 2024, for example, the value of the Birr had fallen by 30% against the US dollar after the government reversed its long-standing fixed exchange rate policy as part of a series of IMF-backed reforms (Yibeltal, 2024). This phenomenon contributes to what has been termed the "dollar debt doom loop," coined by Ruurd Brouwer, CEO of The Currency Ex-change Fund (TCX), a currency hedging mechanism. According to Brouwer (2023), the dollar debt doom loop—closely tied to the con-cept of original sin renders debt suspension initiatives, such as the DSSI, ineffective in the long term.

As the currencies of DSSI participant countries have depreciated by over 20% on average against the US dollar, "every dollar of debt suspended has, in practice, turned into $1.225 of debt in local-currency terms."Ethiopia serves as a prime example. Under the DSSI, Ethiopia's $800 million payment holiday is likely to have been offset by the depreciation of the Ethiopian birr, which increased the effective burden of the country's debts by 35% between 2020 and 2022. This depreciation could conservatively translate into a nearly $10 billion increase in Ethiopia's debt burden.

The Ethiopian case illustrates a major challenge faced by many low-income countries grappling with the consequences of original sin. Exchange rate volatility in these countries is twice as high as in OECD economies, particularly at elevated debt levels (Bacchiocchi and Missale, 2015: 307). If local currencies continue to depreciate, the dollar debt doom loop is likely to intensify, leading to rising debt ser-vicing costs, worsening sovereign credit rat-ings, and increasing refinancing risks. These developments could trigger capital flight, further currency depreciation, and, ultimately, more sovereign debt defaults.

Table 1: DSSI participation and exchange rate risk for low-income countries[6]

Country	DSSI	External debt distress risk	Est. DDS 2020 (% of GDP)[7]	Currency depreciation
Angola	Yes	...	0.7	No
Benin	No	Moderate	0	Yes
Burkina Faso	Yes	Moderate	0.1	Yes
Burundi	Yes	High	0	Yes
Cabo Verde	Yes	Moderate	0.7	Yes
Cameroon	Yes	High	0.5	Yes
Central African Republic	Yes	High	0	Yes
Chad	Yes	High	0	Yes
Comoros	Yes	High	0.3	Yes
Democratic Republic of the Congo	Yes	Moderate	0	Yes
Congo	Yes	In distress	0.6	Yes
Côte d'Ivoire	Yes	Moderate	0.2	Yes
Djibouti	Yes	High	0	No
Ethiopia	Yes	High	0.1	Yes
Gambia	Yes	High	0.5	Yes
Ghana	No	High	0	Yes
Guinea	Yes	Moderate	0.3	Yes
Guinea-Bissau	Yes	High	0	Yes
Kenya	Yes	High	0	Yes
Lesotho	Yes	Moderate	0.1	No
Liberia	Yes	Moderate	0	No
Madagascar	Yes	Moderate	0	Yes
Malawi	Yes	In distress	0	Yes
Mali	Yes	Moderate	0.1	Yes
Mauritania	Yes	Moderate	1.5	Yes
Mozambique	Yes	In distress	0.1	No
Niger	Yes	Moderate	0.1	Yes
Nigeria	No	...	0	Yes
Rwanda	No	Moderate	0	Yes
Sao Tome and Principe	Yes	In distress	0.1	Yes
Senegal	Yes	Moderate	0.2	Yes
Sierra Leone	Yes	High	0.1	Yes
Somalia	No	In distress	14.3	
South Sudan	No	High		Yes
Tanzania	Yes	Moderate	0	Yes
Togo	Yes	Moderate	0.3	Yes
Uganda	Yes	Moderate	0	No
Zambia	Yes	In distress	0.7	No

6. Source: World Bank DSSI and World Development Indicators. For information on currency depreciation, we considered a country's exchange rates, in terms of local currency units relative to the U.S. dollar and calculated it as an annual average based on monthly averages.
7. DDS: Deferred Debt Service

4. Road to dissipation

Given the significant consequences of original sin, there is a strong macroeconomic case for finding viable solutions. Academic and policy discussions have focused on what can be done from both the country and creditor perspectives. At the developing country level, Fujii (2024) suggests diversifying the currencies that denominate external sovereign debt. Since concentration in a single currency can amplify exchange rate pro-cyclicality, less-developed countries may create a buffer by diversifying across international currencies. This strategy can help establish "a less-volatile consumption path by mitigating debt revaluation and exchange rate pro-cyclicality" (Fujii, 2024: 188).

Other scholars emphasize the importance of local capital market development (Han, 2024) and the need for sound macroeconomic policies to support this growth. Apeti, Combes, and Edoh (2024) find that fiscal rules can reduce the share of public debt in foreign currency. By enhancing the credibility of macroeconomic management, fiscal rules could shift market perceptions, making investors less likely to anticipate defaults or inflationary pressures. This, in turn, could make them more willing to purchase local currency-denominated debt from low-income countries (LICs). Additional policies, such as inflation control and debt management measures, could contribute to broader efforts by LICs to develop domestic bond markets (Ul Haque, 2002; Goldstein and Turner, 2004; Burger and Warnock, 2004).

While these remedies offer potential paths forward, there are two major challenges when focusing on bond issuance as a solution to original sin for sub-Saharan Africa—a region with some of the poorest countries globally.

- First, developing deep, liquid, and efficient local currency bond markets in sub-Saharan Africa will likely be a long-term endeavor. Governments would need to maintain low inflation levels, ensure monetary policy credibility, and establish "sound corporate governance and credit information systems" alongside "suitable market infrastructure" (Perry, 2009: 16). Few countries in the region have achieved this level of macroeconomic stability and financial governance—a challenge not unique to Africa.

Additionally, investors may be hesitant to navigate the often complex and conflicting legal and regulatory requirements of these markets. They may also be reluctant to engage with inefficient payment and clearing systems or endure high domestic interest rates. Even multilateral creditors have expressed concerns that their triple-A ratings, which allow them to secure favorable rates on international capital markets, might not be "valued appropriately" when issuing bonds under local laws and infrastructure (EBRD, 2024a: 25).

Low-income countries would therefore need to establish more coordinated, efficient, and less complex regulatory frameworks to attract creditors. This includes ensuring that MDBs and other external creditors can access local funds cost-effectively within a regulatory environment that facilitates asset–liability management (Hoschka, 2005: 7). Countries might also consider granting MDBs certain privileges, such as domestic rating and tax exemptions (e.g., tax-free interest income for MDBs) and reserve liability. These measures would lower funding costs for MDBs and reduce interest rates for the domestic borrowers they support (Hoschka, 2005: 8).

The extensive list of requirements suggests that local capital market development is a long-term solution to original sin and necessitates policy buy-in from borrowing countries as well as support from the creditor community, including international financial institutions. Progress is already underway. MDBs and G7 donors are helping to develop domestic financial markets to promote local currency-denominated bond issuance. As early as 2011, the G20 endorsed an action plan that called on MDBs to assist in LCBM development in developing and emerging market economies. The resulting "diagnostic framework," produced jointly by the EBRD, OECD, World Bank, and IMF (2013), aimed to identify areas of reform to facilitate LCBM growth. In 2018, the African Development Bank (AfDB) launched the African Domestic Bond Fund (ADBF), a pan-African exchange-traded fund that invests in local currency bonds from countries such as South Africa, Kenya, Nigeria, Egypt, Namibia, Botswana, Ghana, and Zambia. The ADBF's goal is to improve liquidity and broaden the investor base in local currency bond markets (ADBF, 2018: 8; AfDB, 2016).

- The second challenge relates to the additional risks LICs may face along the path to LCBM development. Even with MDB support, governments are not entirely shielded from crises. While currency mismatch risks might be mitigated, the concentration of foreign participation in these markets still leaves local currencies vulnerable to global economic fluctuations and shifts in investor risk perceptions (Carstens and Shin, 2019; Shin and von Peter, 2022; Fonay, 2022)[8].

These risks, however, are not insurmountable. Rather, managing these risks and fostering more robust local currency bond markets in sub-Saharan Africa represent long-term goals requiring sustained effort. An alternative, more immediate solution—advocated by those who first introduced the concept of original sin and one that we favor—focuses on direct local currency-denominated loans from some of the largest creditors to African governments: multilateral development banks (Eichengreen and Hausmann, 2003; Hausmann and Rigobon, 2003).

8. South Africa has a substantial presence of foreign investors in the LCBM (Essers et al. 2016; Eichengreen, Hausmann, and Panizza, 2023).

The focus on the private sector in MDB lending is justified. The revenues of MDBs' private sector clients are typically in local currency, and having debt obligations in foreign currency exacerbates foreign exchange risk. This may explain why the International Finance Corporation (IFC), the only MDB exclusively dedicated to private sector lending, is heavily involved in promoting Local Currency Facility (LCF) solutions, with nearly a third of its long-term debt commitments denominated in local currency (H'ng, 2024: 4).

However, as we have emphasized, the same issue applies to governments, which are the primary borrowers of the major MDBs such as IDA. Many sovereign operations financed by MDBs generate revenues entirely in local currency, yet most outstanding debt is denominated in foreign currency, leading to similar—if not more severe—asset–liability mismatches (Hoschka, 2005: 1). Given that public sector lending constitutes the bulk of MDB operations, the current efforts to expand local currency financing to mitigate currency risk for sovereign borrowers remain limited.

Several factors likely contribute to MDBs' preference for foreign currency lending and the limited availability of local currency loans for sovereign borrowers. A key reason is the reluctance of MDBs to assume currency risk on their own balance sheets (Eichengreen et al., 2022: 36). Major MDBs, benefiting from their triple-A credit ratings, fund themselves by issuing hard currency-denominated bonds in international capital markets. As Schclarek and Xu (2023: 1) explain, if MDBs shift towards primarily lending in local currencies, this could create a mismatch between their assets and liabilities, potentially jeopardizing their credit ratings and increasing their funding costs.

Despite these concerns, the risks associated with local currency lending can be effectively managed. Given the macroeconomic and capital market development benefits of local currency-denominated loans—including helping low-income countries overcome original sin and improving long-term debt sustainability—MDBs should expand their local currency financing within sovereign lending operations. They should also broaden the range of currency offerings. We propose several approaches to achieve this.

4.1 Local Currency Financing by MDBs: Challenges

In a recent G20-commissioned report, there were calls for multilateral development banks (MDBs) to "develop a practical offer of an option for local currency lending" (G20, 2024: 43). In response, MDBs such as the African Development Bank (AfDB), Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD), and the World Bank announced efforts to scale up local currency lending and hedging solutions (EBRD, 2024b). These measures aim to protect low- and middle-income countries from exchange rate volatility and the export declines associated with real currency depreciations.

However, this commitment is primarily linked to boosting private investment. Our review of MDB policies and approaches indicates that local currency financing has not been extensively integrated into their lending operations, especially for public sector projects. When MDBs engage in local currency lending, their focus tends to be on private rather than public sector entities and on countries with well-developed capital markets.

For instance, the International Bank for Reconstruction and Development (IBRD) offers a loan conversion scheme with a transaction fee of 0.06% per annum and fixed interest rates. However, this scheme has mostly been used by non-sovereign entities or state-owned enterprises with substantial financing needs and revenues in local currency (World Bank, 2021a; World Bank, 2021b). In sub-Saharan Africa, South Africa's state-owned energy company Eskom has been a notable beneficiary (World Bank, n.d.). In markets with less developed capital markets, the terms of IBRD's local currency loans are often less favorable, with shorter maturity periods of 5-10 years compared to the typical 30-year terms.

Due to its eligibility criteria, which require middle-income status and creditworthiness, IBRD's local currency loans are accessible to only a limited number of sub-Saharan African borrowers. Of the 25 currencies approved for conversion by the IBRD, only four are African—the Egyptian pound, Kenyan shilling, Nigerian naira, and South African rand. For the private sector in less-developed markets, the World Bank Group's private sector arm, the International Finance Corporation (IFC), provides an alternative. Through its concessional lending window, the IDA Private Sector Window (PSW) includes a Local Currency Facility (LCF) designed to provide long-term local currency investments in IDA countries where capital markets are underdeveloped and market solutions are unavailable (World Bank, 2024a).

The EBRD, which recently expanded into sub-Saharan Africa, has committed loan financing in at least 27 local currencies since 1994. By 2022, the EBRD had signed over 1,000 local currency-denominated debt facilities, though these predominantly target private rather than public enterprises. Similarly, the AfDB introduced a framework in 2006 to provide loans denominated in the local currencies of its African member states, although its primary focus has been on eligible private sector clients, with an option available for governments as well (AfDB, 2006). In 2012, the AfDB reinforced this commitment by signing an agreement with the IFC (AfDB, 2012).

4.2 Funding approaches

The first approach involves project-based lending, where an MDB would raise local currency resources specifically to finance a particular project. This method could be especially suit-able for countries with lower demand for loans and disbursements. By responding to actual demand, MDBs could ensure that funding transactions align with loan terms, thereby re-ducing the risk of mismatches (Hoschka, 2005: 11). This approach mirrors some of the mechanisms already in place for private sector operations. For example, the Asian Development Bank (ADB) offers local currency loans to private sector borrowers on a project-by-project basis in selective markets, with interest rates and loan terms tailored to the specific risks and needs of each project.

As a complement or alternative to the project-based model, MDBs could establish a liquidity pool of different local currencies. Many MDBs already have experience with this approach. The ADB, for instance, maintains liquidity pools in six currencies, and the European Bank for Reconstruction and Development (EBRD) has created liquidity pools in at least 14 local currencies (NDB, 2024: 13). The EBRD is also working with the Asian Infrastructure Investment Bank (AIIB) on a concept for a shared local currency treasury, allowing MDBs and development finance institutions to access shared local currency liquidity pools (AIIB, 2024: 13). One challenge with the pool-based approach is the potential for limited demand for lending in a specific local currency for which the MDB has established a liquid pool. Central governments may prefer foreign currency loans, as they provide much-needed foreign exchange, and domestic borrowing may be cheaper than borrowing in local currency from MDBs. Given the currency risk faced by MDBs, a fair premium may be applied to local currency lending products for sovereign bor-rowers. However, how expensive these loans are compared to foreign currency denominated loans can be determined only when the foreign exchange trajectory is known. Given anticipated depreciations, a hard currency loan is likely to be more expensive, even when factoring in the potential risk premium placed on local currency loans. Without longer term risk thinking, borrower countries, and their debt management offices in particular, are unlikely to account for this when making a choice between loan offerings.

To address the uncertainty around future demand for particular local currencies, MDBs could pursue three ac-tions simultaneously:

Demand Projections:

MDBs should carefully estimate demand to determine the appropriate liquidity level for each currency in the pool. Some MDBs, like the AfDB, already factor demand into their local currency loan offerings . The AfDB currently offers local currency-denominated loans in 12 approved African currencies (AfDB, 2020: 8) . For this approach to be effective, MDBs would need to engage in close consultations with government agencies and rely on credible national budget planning processes to produce reliable estimates.

Local Government Financing:

A second initiative involves increasing financing for local governments and sub-sovereign entities, such as state or provincial governments, municipalities, and parastatals. These constituencies often have greater demand for local currency loans since their revenues are generated in local currency. Targeting these borrowers could also unlock co-financing op-portunities for local projects, helping to mobi-lize additional development resources at the sub-sovereign level (Hoschka, 2005: 3, 4).

Strengthening Debt Management Capacity:

A third option focuses on building the capacity of debt management offices in low income countries. Improving their ability to understand and evaluate the trade offs between local currency and foreign currency borrow-ing could increase demand for local currency loans. Some scholars and practitioners suggest that demand for local currency borrowing may be low because debt managers do not fully appreciate the benefits of local currency loans (Paesani and Piga, 2010; Eichen-green et al., 2022: 39).

Recent survey evidence confirms this lack of understanding among debt management offices (DMOs) in LICs, including those in sub-Saharan Africa. Jonasson et al. (2024) find that DMOs generally had a low institutional capacity to engage in foreign currency risk management. Over half of the DMOs surveyed did not even have a foreign currency risk management strategy. Strengthening debt management capacity is therefore critical for demand generation.

4.3 Raising funds

The project-based and pool-based approaches to local currency lending are not mutually exclusive and can be implemented concurrently. The ADB, for example, employs both approaches for its local currency funding (ADB, 2005: 5). Regardless of the approach, MDBs would still need to decide how to raise local currency funds in borrowing countries, prioritizing the most cost-efficient methods. Several options are available, including issuing local currency bonds, borrowing from commercial banks, and entering cross-currency swaps. In this paper, we highlight three routes and briefly assess their feasibility.

BOND ISSUANCE

MDBs routinely issue bonds to raise capital for on-lending. However, raising local currency by issuing bonds in the local bond markets of low-income countries (LICs) is challenging due to the underdevelopment of these markets, as we have previously discussed.

An alternative, based on a proposal by those who introduced the original sin concept, involves MDBs creating an inflation-indexed developing market currency basket. Eichengreen and Hausmann (2003; 2005) and Eichengreen et al. (2007) advocate for MDBs like the World Bank to issue bonds denominated in an inflation-linked emerging market currency index. This index would include the currencies of the 20 largest emerging market and developing economies, weighted by GDP. The proceeds could be used to extend local currency inflation-indexed loans to developing countries, providing governments with insurance in case real exchange rates are lower than expected. Even if real exchange rates align with projections, Bacchiocchi and Missale (2015: 317) argue that “indexed loans would still offer a hedge against cyclical or exchange-rate fluctuations and help stabilize the budget.”

Eichengreen and Hausmann (2003: 8-11) contend that MDBs and G7 countries issuing debt in a composite currency could "stimulate the development of a market with sufficient liquidity to make the bonds easily tradable" and "transform the structure of the global portfolio" as institutional investors follow their lead. This would allow MDBs to avoid currency risk while also opening new markets to other issuers.

MDBs have yet to take steps in this direction, and it remains unclear how many African currencies would be included. Given that Egypt and South Africa are the only African countries represented in the MSCI Emerging Markets Index, which tracks large and mid-cap stocks across 24 emerging markets, the inclusion of African countries might be limited. This could restrict the benefits to African countries' local bond markets. In the short term, creating a currency basket with more low-income countries may be difficult due to long-term trends in currency volatility.

GREEN BONDS

Another opportunity lies in the growing interest among LICs in green bond issuances. MDBs could raise more local currency climate finance by leveraging efforts by governments to develop domestic green bond markets. There is already precedent for this. In 2021, the IFC invested $20 million equivalent in local currency green bonds issued by Romania's Raiffeisen Bank S.A. (RBRO), with proceeds dedicated to climate finance projects (IFC, 2021).

African countries have also begun issuing sovereign green bonds to access climate finance. Nigeria, for example, issued Africa's first sovereign green bond in 2017, raising NGN 10.69 billion in Naira, followed by another NGN 15 billion green bond in 2019 (FSD Africa, 2022). While the initial opportunity for investment may be limited due to the relatively low number of local currency bond issuances[9], MDBs could finance their activities through investments in sovereign green bonds. By following the IFC's model of publicly reporting the use of proceeds and ensuring alignment with the Green Bond Principles, MDBs can scale up green bond issuances in regions with unmet climate financing needs (Sembene, Mitchell, and Brown, H., 2021), while also strengthening domestic capital markets.

Local currency climate finance is expected to attract demand from LICs. Ministers and senior representatives from the Climate Vulnerable Forum (CVF), which includes countries from Africa, Asia, the Caribbean, Latin America, the Middle East, and the Pacific, have already called on MDBs to issue local currency financing for climate projects (V20, 2024). Namibia's Deputy Minister of Finance, Maureen Hinda-Mbuende, echoed this call at the 2024 AfDB annual meeting, advocating for financial mechanisms to mitigate exchange rate risks in clean energy financing (AfDB, 2024).

RECAPITALIZATION WITH SPECIAL DRAWING RIGHTS (SDRS)

Schclarek and Xu (2022) propose another funding mechanism: the recapitalization of MDBs with special drawing rights (SDRs) from developed countries. The hard currency proceeds could then be used to purchase local currency from central banks. This approach would avoid currency mismatches since MDBs would have no hard currency liabilities, while providing recipient countries with hard currency to facilitate import transactions—addressing concerns over the loss of hard currency access as MDBs scale up local currency financing.

9. Seychelles, for example, issued the first ever sovereign blue bond in 2018. The bond, which raised US$15 million, was designed to fund marine and fisheries projects (World Bank, 2018).

However, this solution presents challenges. First, some MDBs have already encountered difficulties with recapitalization. Second, technical issues with capital contributions in SDRs include the potential loss of their reserve asset status (Andrews, 2021). Lastly, local banks in LICs may not meet the rating requirements established by MDBs for swap counterparties (Hoschka, 2005: 11, IBRD, 2021).

CROSS-CURRENCY SWAPS (CCS) AND TCX

When bond issuance or recapitalization proves impractical, MDBs can use cross-currency swaps (CCS) and strategic partnerships with TCX. CCS agreements involve exchanging a future stream of loan principal and inter-est payments in two different currencies. One major limitation of relying on CCS is the lack of active and liquid swap markets in many borrowing countries, restricting MDB engagement. For instance, the IBRD (2021) limits its CCS activities to the most liquid emerging market cur-rencies, given the longer tenors of its loans (10 years or more). Only 25 client currencies are considered liquid enough for IBRD's CCS arrangements.

MDBs may need to explore shorter-term CCS options. They could leverage the services of TCX, a special purpose vehicle partly owned by MDBs, which focuses on mitigating foreign exchange risk for lenders. TCX would be a practical and scalable solution to currency risk, which is additional to the market. It offers swaps where commercial alternatives are either non-existent or insufficient and can hedge longer tenors (over 10 years), even for currencies which are currently seen as illiquid. By entering into CCS agreements with TCX, MDBs could source local currencies for on-lending. Under such agreements, MDBs would sell local currency to TCX in exchange for hard currencies like the US dollar or Euro.

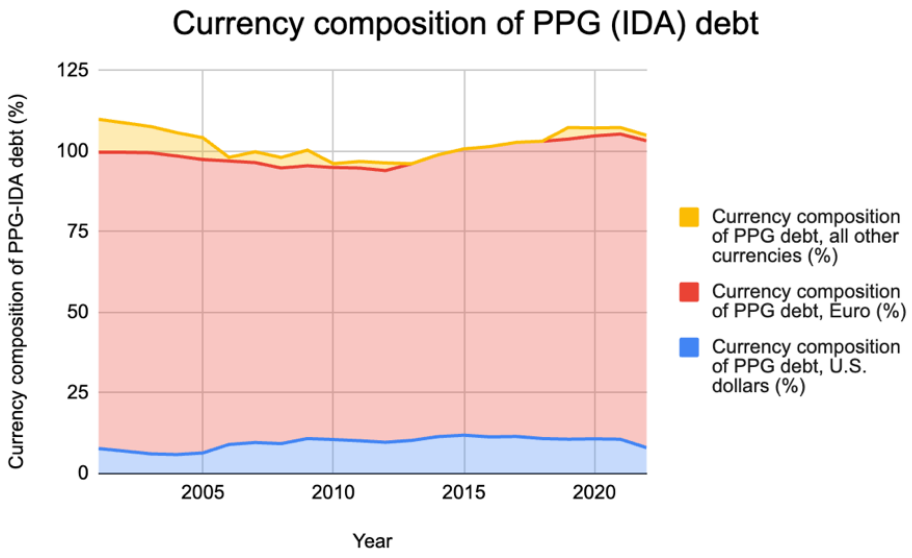
Expanding engagement with TCX offers two key benefits for MDBs. First, TCX would compen-sate MDBs for any losses resulting from depreciation of the local currency against the US dollar or Euro, effectively transferring currency risk. Second, because CCS agreements with TCX can feature either fixed or floating interest rates, this can also address interest rate risk concerns (Cockburn and Jansson, 2023: 30). Particularly for the project-by-project approach, CCS agree-ments with TCX can be structured in smaller amounts and closely aligned with loan disburse-ment schedules (Hoschka, 2005: 10).

MDBs may choose to focus on CCS agreements in the short term, with bond issuance serving as a longer-term solution. Regardless of the funding approach, MDBs should scale up local cur-rency loan offerings. In the next section, we explain why IDA should take the first step.

5. IDA in focus

The World Bank's International Development Association (IDA) is arguably best positioned to lead the expansion of local currency loan offerings to governments. IDA serves as the concessional lending arm of the World Bank, offering grants and low-interest loans (credits) to the world's poorest nations, including 39 African countries (Sembene and Bello, 2024). As shown in Figure 7, most IDA loans to sub-Saharan African countries have been denominated in foreign currencies, with the Euro and US dollar accounting for a significant portion of IDA lending in the region.

Figure 7: Currency of PPG (IDA) debt across Sub-Saharan Africa (excluding high income)



Source: World Bank Data Bank

Yet, there is little justification for IDA to continue offering loans predominantly in foreign currency. As others have argued, lending in local currency would not violate IDA's Articles of Agreement (Griffiths, Panizza, and Taddei, 2020: 5). On the contrary, taking the lead on sovereign local currency financing could address a major threat to debt sustainability among the world's most vulnerable economies. It would also help dissipate original sin without significantly affecting IDA's balance sheets.

Hausmann and Rigobon (2003) suggest that switching to inflation-indexed local currency loans would improve risk management for IDA-eligible countries, as debt repayments would become more predictable and less susceptible to shocks like currency depreciation. For IDA, this approach could increase the likelihood of repayment, as the debt burden would only grow when the borrower's economy is performing well.

Bacchiocchi and Missale (2015) similarly argue that inflation-indexed local currency loans would benefit the largest number of IDA countries compared to GDP-indexed or export indexed loans. The risk premium on such loans would be relatively low, allowing current interest rates to still apply. In fact, the lower risk of debt distress would more than offset the added risk premium (Bacchiocchi and Missale, 2015: 306). Furthermore, they suggest that IDA's portfolio could easily be diversified to manage risks, noting that the volatility of IDA's portfolio is "significantly lower" than average, making the balance sheet resilient even with an increase in local currency sovereign loans.

Lending more in local currency could also have positive externalities for the bond ratings of IDA-eligible countries. Original sin often forces low-income countries (LICs) to accumulate additional foreign reserves as a buffer against local currency depreciation, which raises debt servicing costs (OECD, 2023). International reserves play a crucial role in determining bond ratings, sovereign risk premiums, and bond spreads (Mpapalika and Malikane, 2019). Countries that lack high export levels become even more vulnerable to the pitfalls of original sin[10]. For many low-income sub-Saharan African countries, debt owed to MDBs like IDA constitutes more than a third of their total debt. If this debt were denominated in local currency, it could prompt credit rating agencies to rate LIC debt in local currency rather than based on foreign reserves. Such a shift could reduce the need for large international reserves, leading to better credit ratings, more favorable interest rates, and improved debt sustainability for LICs.

This is not necessarily an argument in favor of lower international reserves. In fact, a country stands to benefit from holding a significant level of reserves because of the buffer it provides from external shocks, like sudden swings in the foreign exchange rate. It, however, calls attention to the benefits of lending in local currencies and the rating of LIC debt in those local currencies, which would help countries facing a shortfall in hard currency reserves.

However, should IDA begin offering local currency loans as its primary lending option, adverse policy incentives could arise. As Bacchiocchi and Missale (2015: 325) and Griffiths, Panizza, and Taddei (2020: 6) point out, adverse selection could occur, where only countries anticipating currency depreciation apply for IDA local currency loans. Additionally, a moral hazard problem could emerge, with countries manipulating economic policy to favor currency depreciation and reduce their debt burdens. In such cases, IDA would not be protected against a government's deliberate actions.

Griffiths, Panizza, and Taddei (2020: 6) suggest that IDA could balance its portfolio between domestic and foreign currencies, arguing that governments would still have an incentive to borrow part of their IDA allocation in local currency due to its concessional nature and its benefits for debt sustainability compared to foreign currency-denominated loans.

Despite these advantages and manageable risks, it is surprising that IDA or other major MDBs have not yet pursued this initiative. To further emphasize why IDA, specifically, should take a leading role in local currency lending for sovereign operations, we highlight four additional reasons: the profile of IDA-eligible countries, IDA's capacity-building network, its financing model, and its low-cost loans.

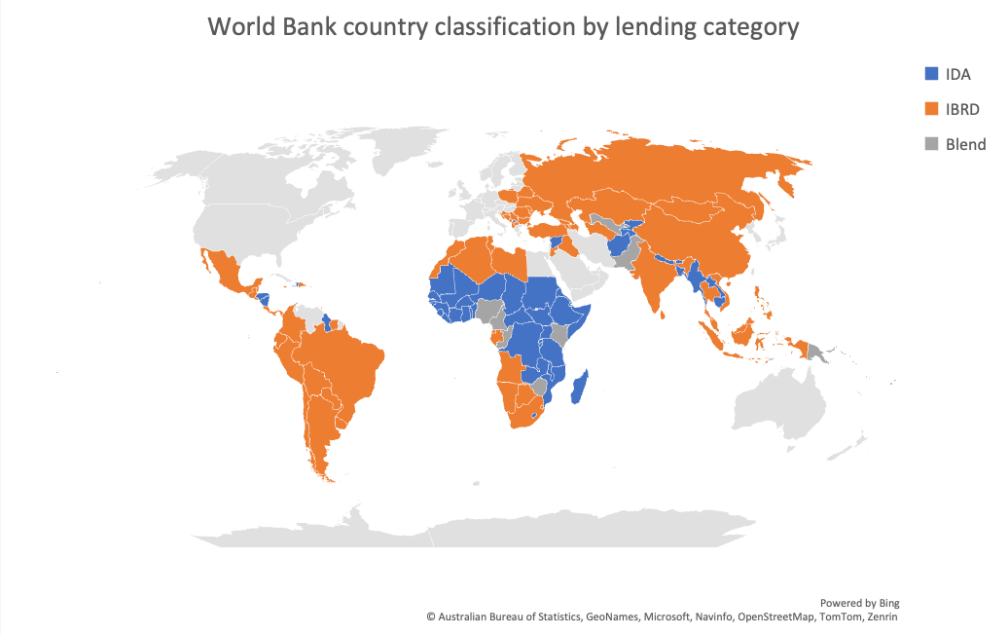
Lending more in local currency could also have positive externalities for the bond ratings of IDA-eligible countries.

10. Exports are often a source of foreign currency income.

5.1 IDA-eligible countries

The first reason focuses on the profile of IDA-eligible countries, particularly sub-Saharan African nations, which collectively represent slightly more than half of the 75 countries eligible for IDA funding (see Figure 8). These countries are among the poorest and least creditworthy in the world, and as highlighted in the previous section, they have yet to overcome the problem of original sin. Many are also vulnerable to exchange rate shocks. A 2005 study by DePlaa and Yi found that the reduction in the debt-to-GDP ratio following a negative exchange rate shock is 0.32 standard deviations lower under Hausmann and Rigobon's (2003) proposal for inflation-indexed local currency loans compared to current IDA practices. Therefore, the governments of IDA-eligible countries would stand to benefit significantly from the introduction of local currency loan offerings.

Figure 8: World Bank country classification



Source: World Bank Data Bank

5.2 Capacity-building

IDA-eligible countries also have a limited capacity to manage currency risks, which often reflects a lack of financial resources or the inability to recruit staff with the necessary expertise. Through various programs and trust funds, the World Bank has worked closely with the debt management offices of these countries. For instance, the Debt Management Facility (DMF), jointly administered with the IMF, is a multi-donor trust fund that provides advisory services, training, and peer-to-peer learning aimed at strengthening debt management capacity, processes, and institutions in developing countries.

More than any other multilateral development bank, the World Bank has the resources to provide the technical assistance needed to improve awareness of foreign exchange (FX) risk mitigation options, including local currency loans. Leveraging IDA's potential contribution in this area is crucial because many government agencies, in their current state, may take time to fully understand and identify products that address concerns around currency devaluation and debt sustainability. As previously noted, demand for local currency loans is likely to vary across countries, and awareness of FX risk mitigation options is equally limited.

If IDA were to introduce local currency sovereign loans, it would likely need to incorporate a fair currency premium to account for potential future devaluation. Several scholars have raised concerns about politicians with short-term horizons (Griffiths, Panizza, and Taddei, 2020: 5; Eichengreen et al., 2022: 36). Politicians or officials who do not expect to remain in office long enough to experience the long-term benefits of local currency debt may view the premium as expensive and continue to favor foreign currency debt despite its risks.

More informed policymakers, on the other hand, may better understand the rationale behind the premium. As Eichengreen et al. (2022: 36) suggest, such policymakers, with a greater appreciation for risk management, could advocate for safer local currency debt from IDA or, at the very least, aim for a manageable balance of foreign and local currency debt in their IDA portfolio. However, this would require capacity-building efforts, where IDA, through its country offices and its collaboration with other development partners, holds both network and financial advantages.

5.3 Financing model

A third reason for advocating IDA's leadership in local currency sovereign lending lies in the advantages offered by its financing model. Historically, before IDA18, IDA largely funded itself through contributions from member state governments on a three-year replenishment cycle[11]. While IDA18 introduced capital market financing as a new funding innovation, IDA can still leverage the fiscal resources provided directly by donors to offer more local currency loans.

Unlike international capital markets, which typically do not accept local currency denomi-nations, the fiscal resources provided by donors are in their respective national currencies (if freely convertible) or in Special Drawing Rights (SDRs). This creates a potential source of lo-cal currency for IDA. As Hausmann and Rigobon (2003) suggest, IDA could convert or swap these currencies to provide inflation-indexed, local currency-denominated loans. Additionally, if low-income countries pay their contributions in local currencies, IDA could directly on-lend in those same currencies.

This set-up might be more difficult for IBRD, the World Bank's non-concessional lending window, which is funded primarily through capital market financing. International capital markets largely demand debt to be denominated in hard currencies, like the US dollar. To ensure that it is well-positioned to repay its bonds, an international financial institution, like IBRD, would need to receive repayments in currencies in which it can settle its debt obligations. If it were to lend mostly in the local currencies of its borrowers, IBRD risks a currency mismatch between its assets, which are the loans in LIC currencies, and its liabilities, which are the hard currency-denominated bonds issued in international capital markets. The concern over financial stability due to this currency mismatch is less of an issue for IDA because of its current financing model.

5.4 Cost of loans

As a fourth reason, we argue that the cost of IDA local currency loans can be cheaper than IDA credits with low interest rates if recipient countries regularly experience significant drops in local currency value—something we've seen frequently. For instance, in Malawi, IDA holds the largest share of foreign currency-denominated external debt. A shortage of foreign exchange reserves and pressure on the exchange rate led the central bank to devalue the local currency, the Kwacha, by 26%. This not only triggered inflation but also worsened Malawi's debt position by increasing the Kwacha value of its foreign currency-denominated debt (Ministry of Finance of Malawi, 2023: 12; World Bank, 2024: 35-36).

11. Additional funds are provided from IBRD and IFC income and loan repayments from earlier IDA credits.

With local currency offerings, recipient governments, such as Malawi's, would face a choice: accept a low-interest dollar-denominated IDA loan (e.g., 0.5 to 0.75% interest) or a local currency loan with a higher interest rate (due to the risk premium). If their local currency depreciates by 20-25% or more annually, this depreciation would increase the effective cost of the concessional hard currency loan, likely surpassing the cost of the premium. In such cases, IDA's concessional local currency loans would become the more attractive option.

However, this approach comes with risks for IDA. When lending in local currency, IDA may gain in US dollars if the local currency appreciates or incur losses when it depreciates. Given historical trends, depreciation is far more likely than appreciation. If the dollar value of its local currency-denominated loans declines between approval and repayment, IDA could receive less in hard currency terms than initially offered.

To mitigate these risks, we propose donor-funded FX risk guarantees. These guarantees would compensate IDA or other MDBs for losses resulting from currency depreciation. This could be implemented through a donor-funded World Bank trust fund specifically dedicated to risk management for local currency loans. If IDA experiences losses on local currency loan repayments due to depreciation, it could submit a claim to the trust fund for reimbursement. This system would work similarly to IDA's Private Sector Window (PSW), where the IFC can request reimbursement from IDA for losses incurred on local currency investments through the Local Currency Facility (LCF).

Providing FX guarantees can be costly, and sufficient resources would be needed to cover potential losses, requiring significant donor support. For the PSW, IDA sets aside 100% of the capital for PSW obligations (approximately $1.2 billion for 2023), assuming all obligations would result in full losses, even though actual payouts under PSW guarantees have only totaled $1 million (Nonay, Motta, and Grigorov, 2024). There are indications that donors would support a broader initiative extending local currency financing solutions to sovereign loans, given their interest in such strategies.

Even without FX guarantees, IDA is better positioned to manage foreign exchange or currency risk than low-income countries. . It can scale up TCX, an already existing currency hedging solution. This would still allow IDA to can account for this risk on its balance sheet, bear the cost of currency management, and engage in hedging contracts while still main-taining the concessionality of its loans.

Policy recommendations and Conclusion

IDA, in collaboration with other multilateral development banks (MDBs), can play a crucial role in helping African countries move towards debt sustainability through local currency financing for sovereign operations. We propose three key policy actions that should be implemented:

1. Long-term: Capital Market Development

Deep, efficient, and well-regulated domestic capital markets are essential for accessing long-term local currency financing. While capital market development takes time, IDA and other MDBs should continue laying the foundation to help low-income countries (LICs) strengthen their capital markets. This includes supporting periodic local bond issuances, investing in sovereign bonds (including green bonds), and assisting in regulatory reform efforts.

2. Medium-to-Short Term: Sovereign Debt Management

Our recommendations for sovereign debt management are two-fold. First, borrowers must demand local currency alternatives, which requires greater awareness of hedged loan options. Significant knowledge gaps likely exist among debt management offices in LICs. IDA should leverage its extensive knowledge-sharing networks to provide training and technical assistance to policymakers in sub-Saharan Africa and other LICs to close these gaps. Peer-learning activities could also help countries learn from international best practices.

Second, any shift towards local currency alternatives must be accompanied by efforts to manage the buildup of sovereign debt in LICs, which poses risks to economic recovery. Developing countries must manage their debt proactively to minimize economic and social costs and ensure that public spending accelerates recovery. Ongoing efforts to encourage debt reprofiling—restructuring loans to reduce the net present value of liabilities and address exposure risks—should continue.

3. Immediate Term: Local Currency Indexed Loans

IDA should take the lead in offering local currency loans. While there are various approaches IDA could use to raise funds in local currencies, offering these loans to LICs is essential for their financial resilience, economic stability, and debt sustainability. The favorable lending rates typically associated with IDA concessional loans should apply to local currency loans as well. To mitigate moral hazard, IDA should maintain a balanced portfolio of both foreign and local currency loans.

For countries with currencies pegged to major hard currencies like the US dollar or the Euro, IDA should provide a higher proportion of foreign currency loans in their overall portfolio, given the ease of convertibility. For example, members of the West African Economic and Monetary Union (WAEMU) and the Central African Economic and Monetary Community (CEMAC) could automatically convert Euro-denominated loans into the CFA franc[12].

For countries without fully convertible currencies, we recommend following an approach proposed by Griffiths, Panizza, and Taddei (2020). These countries should repay foreign currency loans in foreign currency at the prevailing exchange rate at the loan's due date, with IDA's exposure to exchange rate fluctuations being "theoretically equivalent" to lending in local currency (Griffiths, Panizza, and Taddei, 2020: 5). In addition, the hard currency portion of these loans should include a grant to hedge currency risk—an approach currently under review by the Green Climate Fund (GCF) as part of its pilot local currency financing program (GCF, 2023).

Where a grant element is not feasible, IDA may offer a portion of the lending portfolio as synthetic local currency financing in partnership with TCX. Synthetic local currency loans simulate local currency financing by indexing payments of interest and principal (paid in hard currency) to local currency interest and exchange rates. A typical transaction would see IDA disburse the hard currency equivalent of the local currency loan amount using the prevailing exchange rate. The borrowing country would also make interest and principal repayments denominated in the same lending currency, but these payments would be indexed to a local currency interest and exchange rate determined at the time of the loan agreement. This provides exposure (synthetically) similar to a local currency-denominated loan (AfDB, 2008). A swap transaction with TCX hedges the interest rate and currency risk exposure created by the indexation mechanism, ensuring that IDA always receives the planned hard currency amount (IFU, 2009: 3). The borrowing country still receives much-needed hard currency (for a portion of its portfolio), but IDA is able to mitigate currency risk on its side.

12. The West African Development Bank (BOAD), which lends to WAEMU countries, routinely converts foreign currency denominated lending resources to Euros via swaps to avoid exchange rate risks. BOAD only lends in the local currency (XOF) of its member states.

CONCLUSION

Our recommendations come at a critical time, as an increasing number of LICs face rising debt burdens. We also acknowledge the G20's call for MDBs to develop practical options for local currency lending, and the forthcoming IDA replenishment presents a valuable opportunity to make a significant impact. With 75 of the world's poorest countries relying on its funds, IDA stands to benefit the most from offering local currency loans. Positioned at the center of the global multilateral development bank architecture, IDA possesses the resources and risk management capacity to implement these recommendations. IDA must take the lead.

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