Local currency lending in fragile states: Follow up on recent proposals and the way forward

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- The challenge of delivering finance in local currency remains a critical issue, particularly for borrowers in fragile and conflict-affected states, given these countries' profound and complex social, political, and economic vulnerabilities.
- The Development Finance Institution (DFI) Fragility Forum 2023 focused on local currency (LCY) lending to generate momentum around developing scalable and viable local currency solutions. The proposals discussed included an innovative approach to treasury risk management, technical assistance to central banks, cross-currency swaps with central banks, local currency credit guarantees, and an onshore treasury platform.
- With constrained public finances, mobilising private capital is the only viable solution for addressing challenges like the United Nations Sustainable Development Goals (SDGs) and climate change. Over time, as market development progresses, LCY finance could become more widely available across all sectors.
- To achieve further progress in bolstering LCY lending, DFIs should strengthen internal capacity, raise awareness, engage stakeholders, and enhance collaboration. Local policy priorities include improving governance, transparency, rule of law, macroeconomic policies, and financial stability.

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Introduction

This policy brief consolidates recent progress based on activities and engagements following last year's Development Finance Institution (DFI) Fragility Forum. It highlights ongoing challenges and identifies opportunities to mitigate foreign exchange (FX) risk in local currency (LCY) lending in fragile states, aiming to support viable financing solutions in these complex settings.

Why local currency lending remains a critical issue in fragile states

Fragile states are characterised by profound and complex social, political, and economic vulnerabilities, underscoring the critical importance of LCY financing and lending for several reasons.

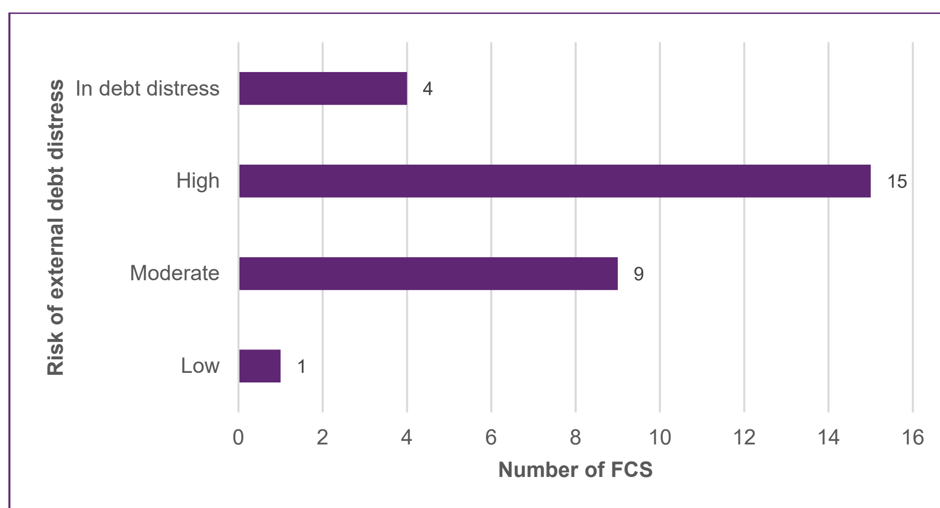
First, these countries are disproportionately affected by fiscal constraints, limited domestic savings, volatile exchange rates, high inflation, substantial debt burdens, and restricted access to financial services (International Monetary Fund, 2022). As a result, they often encounter significant **currency risk** when borrowing externally, stemming from their inability to borrow in their own currencies, also known as the "original sin." The combination of weak macroeconomic fundamentals (such as growth, inflation, and employment) along with exchange rate volatility (resulting from an overreliance on natural resources and other structural weaknesses) increases the likelihood of these countries facing mounting debt burdens and debt distress (see Figure 1). This is further compounded by escalating repayment obligations, currency mismatches, perceived risks, and inadequate debt-carrying capacities. These issues tend to exacerbate existing political, social, and structural vulnerabilities, hindering efforts to escape the fragility trap. **Local private sector borrowers face similar challenges, including potential escalating funding costs, volatile earnings, and financial distress.** Therefore, LCY lending can potentially mitigate currency risk and exposure to exchange rate volatility by making economic agents more resilient to currency shocks. However, political stability and comprehensive, sustained economic and financial sector reforms are needed to create an environment conducive to such lending.

Second, central banks in fragile states already suffer from poor credibility,[1] and foreign currency exposures further constrain their ability to conduct an independent monetary policy. This hampers the central bank's capacity to pursue its core objectives of economic growth and stabilising inflation, as exchange rate fluctuations often necessitate interventions in the foreign exchange market.

[1] Evidenced by persistent macroeconomic instability, volatile inflation and exchange rates, dollarization, and weak institutional quality.

Ultimately, this may lead to the circulation of multiple currencies within the economy (i.e., dollarization), the imposition of foreign exchange restrictions, and the emergence of parallel markets, all of which cause further distortions. Therefore, as part of broad-based reform measures, the development of local money markets and increased domestic savings in LCY can **foster monetary policy autonomy**, providing greater flexibility to policymakers and enabling them to implement monetary policy measures more effectively.

Figure 1: Fragile states at risk of external debt distress



Source: IMF, 2024
Low: Myanmar (2021)
Moderate: Burkina Faso (2023), Democratic Republic of Congo (2023), Mali (2023), Niger (2023), Somalia (2023), Republic of Yemen (2014), Federated States of Micronesia (2024), Solomon Islands (2023), and Timor-Leste (2024)
High: Afghanistan (2021), Cameroon (2024), Central African Republic (2023), Ethiopia (2020), Mozambique (2024), South Sudan (2023), Burundi (2023), Chad (2023), Comoros (2024), Guinea-Bissau (2023), Haiti (202), Kiribati (2023), Marshall Islands (2023), Papua New Guinea (2023), and Tuvalu (2023)
In debt distress: Sudan (2021), Republic of Congo (2024), São Tomé and Príncipe (2022), and Zimbabwe (2022)
Data for Eritrea, Iraq, Kosovo, Lebanon, Libya, Nigeria, Syrian Arab Republic, Ukraine, Venezuela, West Bank and Gaza (territory) was not available.

Third, access to finance, widely regarded as a key driver of economic growth and development, is severely limited in fragile states. Pioneering firms, small and medium enterprises (SMEs), and entrepreneurs often face significant obstacles when accessing finance, including limited credit, inadequate financial services, high transaction costs, and stringent collateral requirements. These challenges are further compounded by weak institutions, political instability, and significant market imperfections (such as information asymmetries, inadequate credit markets, corruption, and weak property rights protection and enforcement of legal contracts). If these issues are properly addressed, **LCY financing could be transformative in alleviating credit constraints.** They can create better alignment between loan terms and the income streams of borrowers, offering financial products tailored to the needs of local businesses and communities. By expanding access to finance and promoting financial inclusion, the financial

sector can play a crucial role in poverty reduction and inclusive economic development.

Fourth, related to the above point, LCY financing can potentially **reduce vulnerability to external shocks by enhancing financial stability**. For example, during financial crises, unexpected capital outflows can have profoundly adverse effects on exchange rates and the wider economy, leading to depletion of foreign currency reserves, higher borrowing costs, currency depreciation, banking and corporate sector distress, and inflationary pressures, among other issues. Given these risks, LCY financing can reduce dependence on foreign currencies, thereby mitigating vulnerability to external shocks and enhancing the resilience of the financial sector. However, as the experience of more advanced emerging markets shows, this can act as a double-edged sword under certain conditions. On the one hand, LCY bonds may attract more foreign investors to domestic bond markets, leading foreign investors to assume disproportionate currency risk and exacerbating existing currency mismatch problems. On the other hand, local banks may increase their exposure to balance sheet risks, such as currency mismatches, through heightened lending in foreign currencies. These developments can introduce financial system vulnerabilities and potentially lead to increased external capital flows. Given significant currency mismatches, central banks may find it challenging to use exchange rate adjustments to respond to external shocks, making the economy more susceptible to increased volatile capital flows – a phenomenon known as "original sin redux" (Carstens and Shin, 2019). Despite these scenarios, there is no clear-cut answer as to whether LCY finance is inherently beneficial or detrimental to financial stability. This is because improved LCY finance in the domestic market does not automatically translate into increased foreign investment in LCY bonds, as portfolio flow liberalisation can be managed independently. Similarly, local banks' hard currency lending may not pose financial system vulnerabilities if regulatory capacity is sufficiently strengthened.

Update on the recommendations of the DFI Fragility Forum 2023

DFIs have taken various approaches to tackle the challenges – notably the high all-in lending rates and hedging the related risks, including on the most-followed offshore route – of LCY lending in fragile states. Attempts to solve these issues involve policy dialogue, subsidy, political risk insurance, FX risk-absorption, credit risk-absorption, and operating un-hedged. **None of these methods have enabled a significant scale-up of LCY lending in fragile states for DFIs as a whole**.

The DFI Fragility Forum 2023 selected LCY lending/ investing as the core agenda to create momentum around developing scalable and viable LCY solutions. The Forum Communiqué retained three forward-looking proposals from the IGC report (henceforth Report) titled ‘Mitigating Foreign Exchange Risk in Local Currency Lending in Fragile States’ that focused on **strengthening DFIs’ ability to source LCY onshore**, next to the already well-established offshore route. These proposals were:

(i) Technical assistance to central banks and financial institutions in order to create a macroeconomic environment conducive to local money market development and financial stability.
(ii) Improving access to LCY via central bank swaps and LCY credit guarantees covering both financing and derivative transactions.
(iii) A shared DFI LCY platform operating onshore.

The Report encouraged DFI treasuries to **expand onshore market operations in order to develop the local markets while simultaneously sourcing LCY with local counterparts in the domestic money market**.

The onshore route can bring about indisputable **advantages**, including:

- Better pricing – as onshore prices reflect real market flows, they tend to be steadier and (with some exceptions) typically lower when compared to offshore prices.
- Delivery of true LCY, free of transfer and convertibility risk, and without exposure to spot market liquidity risk.
- Mobilisation of LCY liquidity that is often sitting idle in local financial systems characterised by liquidity hoarding. With improved balance sheet management, local banks can better finance the domestic economy and fully play their role in the local market, acting as a counterpart to DFIs in market transactions.

However, the onshore approach also presents **challenges** that currently hold back its ready adoption by most DFIs. These obstacles require DFIs to adapt their risk management policies in order to accommodate for market counterparts and investable assets with lower credit ratings, heightened legal and operational risk, often significant liquidity risk, and some residual market risk exposure. Further, operating in the domestic market brings additional practical hurdles, including the need to open a local cash and securities account. It also requires deep knowledge of the local context and close monitoring of the market’s situation.

To overcome these challenges, the innovative and transformative proposal to create a **shared LCY platform holds the greatest potential**.

LCY platform acting as an onshore treasury capability

With a view to facilitating the approach of onshore markets and coordinating policy dialogue interventions on money market development, the Report proposed the creation of an LCY platform acting as an onshore treasury capability that would constitute an interface with local markets and also deliver the related technical assistance. Such technical assistance is aimed at strengthening the macro-policy environment, as highlighted in the Report, while equipping the local market with the required tools and basic building blocks.

Leveraging the European Bank for Reconstruction and Development's (EBRD) extensive experience in onshore hedging, the idea evolved within the LCY Task Force into a fully-fledged DFI shared treasury operation managing LCY hedging on behalf of the DFI community. The **objective** is to relinquish back-to-back hedging and lock-in funding opportunities as they arise across instruments, making use of favourable market configurations. By managing liquidity pools in LCY, such a treasury operation can:

- Act as a hedge provider for DFIs, delivering true LCY when possible;
- Hold different types of LCY assets, including local bank deposits, loans, local government bonds, and derivatives;
- Rely on various instruments on the LCY liabilities side, including borrowings from local and international banks, bond issuances, derivatives, and central bank swap facilities;
- Resort to non-deliverable instruments or offshore hedging when there is no reasonable onshore alternative.

A shared DFI treasury operation entails numerous **advantages** in addition to the previously listed benefits of onshore hedging:

- It is able to back LCY loans with more flexible features.
- It optimises the use of shareholder and donor support by pooling resources, as it essentially takes out the need to replicate the model in each DFI.
- It allows DFIs to proceed at a fast pace with scaling true LCY lending thanks to an off-the-shelf hedging solution in Emerging Markets and Developing Countries (EMDC).
- It opens the possibility for all DFIs, including the smallest, to operate in true LCY, as this solution is available to all interested DFIs on a level playing field as soon as it starts operating.

It is crucial to emphasise that the success of the proposed platform's treasury function is inherently dependent on robust **market development** efforts. These two aspects are inseparable – without effective market development, the platform cannot succeed. Moreover, the platform is ideally positioned to lead and coordinate the necessary technical assistance for this market development, making it a critical driver of the overall initiative's success. Therefore, and in line with the recommendations of the Report, the above-described treasury activities must be combined with money market development work framed by the Money Market Development Framework (MMDF), which enables the alignment of key messages among DFIs. Its participation in the market brings first-hand experience of local liquidity bottlenecks and credibility in policy dialogue with local stakeholders.

Onshore and offshore routes are complementary, and both are needed

With The Currency Exchange Fund (TCX) often the only provider of offshore hedging[2] in fragile states, the shared treasury platform and TCX would essentially constitute the two alternative suppliers of LCY hedges for DFIs in fragile states' currencies. These two sources **are complementary, primarily because they rely on different risk management models** that can deal with different situations across countries.

The **onshore route follows a rather classic risk management approach** based on LCY borrowings and LCY assets of matching aggregate size. The model does not require taking open foreign exchange (FX) risk. Instead, when operating onshore, the platform takes local credit and some market and liquidity risk. For that reason, it can function with a rather favourable leverage ratio. As a reference, EBRD indicates that its LCY activities require roughly EUR 250 million of capital, which allows it to finance as much as EUR five billion of LCY loans in 23 countries and support a liquidity portfolio of EUR one billion.

For all its advantages, the **onshore route can be hampered by two significant constraints**: it depends on **domestic market activity and size**. Besides being often less developed in fragile states, both factors may shift in time. A **local market might be non-existent or become inactive** due to political, macro, or regulatory reasons.

By contrast, **TCX is designed to function where there is no market**. TCX is a fund that takes open FX and interest rate risk with global diversification of

[2] Also called non-deliverable hedging. The payments related to such transactions take place in synthetic LCY, i.e. they consist of USD flows indexed on LCY parameters.

currencies and geographies as a risk mitigation technique. It follows that the TCX model is more capital intensive, with TCX's maximum leverage set at six times capital. TCX, however, benefits from a major advantage: it can **free up capital** by selling risk to international investors, who have the potential of vastly broadening the hedging capacity of the offshore route.

Crucially, offshore (and onshore) pricing improves when the local market situation improves. As a consequence, creating a favourable local environment strengthens both the onshore and offshore routes, which are needed to cover constantly evolving fragile state contexts.

Continued challenges

Turning the joint DFI LCY platform into a reality

Formalising a shared capability that is a joint DFI initiative remains a significant challenge. Besides capital, the following is required for the most effective impact:

- Local knowledge and connections.
- Centralisation of money market development – or at least rigorous coordination between stakeholders of interventions around money market development.
- Alignment of objectives and priorities among DFI treasuries on money market development.
- Treasury operators with a good understanding of the local context and the resources to conduct high-level policy dialogue, including with central banks on macro and monetary policy operations.

An International Financial Institution (IFI) status or IFI affiliation would help the platform fully deliver on its ambitions. This is because established country agreements, development credentials, privileges, and immunities help with kicking off onshore operations, including LCY conversions and transfers. Moreover, high-level local connections and a neutral party's deep understanding of the local context support policy dialogue effectiveness.

Creating a new legal entity could prove a difficult and lengthy process. Larger DFIs might decide to develop in-house onshore trading capabilities. The platform could be a standalone entity, capitalised by the DFIs' users of the vehicle. Alternatively, certain institutions with country agreements could host local platforms (e.g. regional DFIs) each with their specific geographic remit. The approach requires detailed costing of the services and resources involved. Further, country agreements would need to be checked for whether they allow

this. Stakeholders might also consider the value of having a common servicing function for reasons of (cost) efficiency.

Creating the required enabling environment in fragile states

A macroeconomic policy **favourable to market development** is committed to low inflation, fiscal prudence, and a transparent exchange rate policy. Few fragile economies offer a good perspective of creating such an environment in the foreseeable future. About a third of fragile state central banks manage a pegged currency and no more than three of them implement a monetary policy framework based on a floating exchange rate regime as shown in Annex 1.

Further, buy-in from local authorities is an essential condition for **genuine reform**, as highlighted in the Report. In several fragile states, the consistent commitment required to introduce the necessary legal reforms and create the basic market building blocks is lacking, creating a compelling case for the role of **technical assistance** in addressing fragile countries' structural challenges.

Still, strengthening the financial sector's stability can lay important foundations. Sharing knowledge and expertise on financial supervision and macro-prudential policies in fragile contexts can have enormous effects in the short and medium term, paving the way for improved balance sheet management and better liquidity circulation within the financial system.

Way forward

Several pre-conditions are necessary to capitalise on a shared LCY platform. The key stakeholders, namely, DFIs and policymakers, should establish these prerequisites.

For DFIs

The internal structures of DFIs should be adapted to ensure that client-facing and middle-office functions, including risk and credit departments, are adequately prepared for LCY lending through this platform. This involves forming transversal working groups that adopt an integrated approach to address the challenges and opportunities of LCY lending, facilitating knowledge sharing, enhancing internal capacity, and ensuring alignment and improved coordination across diverse departments.

Additionally, it is crucial to raise awareness and build capacity by engaging shareholders to secure their support, capacitating borrowers to ensure their understanding and involvement in managing FX risk, and providing technical assistance to create a conducive macro-policy environment.

Furthermore, strengthening collaboration among DFIs in the LCY space is essential. This collaboration fosters knowledge and experience sharing, facilitates innovations and transformational solutions, and creates synergies to overcome challenges collectively.

Lastly, assessing demand from both DFIs and governments will be critical while ensuring effective coordination. For instance, larger DFIs, like major Multilateral Development Banks (MDBs) have been independently developing liquidity pools in a fragmented way – these efforts could be better coordinated or even consolidated for greater impact.

For policymakers in fragile states

Political instability and weak institutions distort economic incentives and negatively impact market information, necessitating sustained efforts to address these issues. Additionally, improving the macroeconomic policy environment is critical, particularly through prudent fiscal policies, effective monetary and exchange policies, and enhancing overall economic stability. Strengthening governance, transparency, and the rule of law by combating corruption, enhancing legal and regulatory frameworks, and bolstering investor confidence is also essential. Above all, financial stability is paramount, requiring efforts to strengthen financial infrastructure, deepen financial markets, and enhance banking regulation and supervision. Technical assistance will be crucial in supporting central banks to implement measures that achieve financial stability.

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ANNEX

World Bank FY24 List of Fragile and Conflict-Affected Situations	Currency code	Currency	*Exchange Arrangement* Exchange rate classification	*Monetary policy framework* Exchange rate anchor	Population (mn) 2022	GDP per capita (current USD) 2022	*Fragile States Index* Rank 2023	Score 2023
CONFLICT								
Afghanistan	AFN	Afghani	Crawl-like arrangement		41.1	356*	6th	106.6
Burkina Faso	XOF	CFA Franc BCEAO	Conventional peg	Euro	22.7	830	21st	94
Cameroon	XAF	CFA Franc BEAC	Conventional peg	Euro	27.9	1563	23rd	94
Central African Republic	XAF	CFA Franc BEAC	Conventional peg	Euro	5.6	427	8th	105.7
Congo, Democratic Republic of	CDF	Congolese Franc	Crawl-like arrangement		99.0	654	4th	107.2
Ethiopia	ETB	Ethiopian Birr	Crawl-like arrangement		123.4	1028	11th	100.4
Iraq	IQD	Iraqi Dinar	Conventional peg	US Dollar	44.5	5937	27th	91.4
Mali	XOF	CFA Franc BCEAO	Conventional peg	Euro	22.6	833	13th	99.5
Mozambique	MZN	Mozambique Metical	Stabilized arrangement		33.0	558	22nd	94
Myanmar	MMK	Kyat	Other managed arrangement		54.2	1149	12th	100.2
Niger	XOF	CFA Franc BCEAO	Conventional peg	Euro	26.2	585	24th	93.4
Nigeria	NGN	Naira	Stabilized arrangement		218.5	2163	15th	98
Somalia	SOS	Somali Shilling	Free floating		17.6	592	1st	111.9
South Sudan	SSP	South Sudanese Pound	Other managed arrangement		10.9	1072*	3rd	108.5
Sudan	SDG	Sudanese Pound	Stabilized arrangement		46.9	1102	7th	106.2
Syrian Arab Republic	SYP	Syrian Pound	Other managed arrangement	Composite	22.1	421*	5th	107.1
Ukraine	UAH	Hryvnia	Floating		38.0	4534	18th	95.9
West Bank and Gaza (territory)	USD, JOD, NIS	US Dollar, Jordanian Dinar, Nea Allari Shequel	No separate legal tender		5.0	3789	34th	87.9
Yemen, Republic of	YER	Yemeni Rial	Floating		33.7	650	2nd	108.9
INSTITUTIONAL AND SOCIAL FRAGILITY								
Burundi	BIF	Burundi Franc	Crawl-like arrangement		12.9	259	20th	94.2
Chad	XAF	CFA Franc BEAC	Conventional peg	Euro	17.7	717	9th	104.6
Comoros	KMF	Comorian Franc	Conventional peg	Euro	0.8	1485	45th	82.2
Congo, Republic of	XAF	CFA Franc BEAC	Conventional peg	Euro	6.0	2649	28th	90.7
Eritrea	ERN	Nakfa	Conventional peg	US Dollar	3.7	644*	19th	94.5
Guinea-Bissau	XOF	CFA Franc BCEAO	Conventional peg	Euro	2.1	776	31st	89.9
Haiti	HTG / USD	Gourde / US Dollar	Other managed arrangement		11.6	1748	10th	102.9
Kiribati	AUD	Australian Dollar	No separate legal tender	Other	0.1	1702		
Kosovo	EUR	Euro	No separate legal tender	Euro	1.8	5340		
Lebanon	LBP	Lebanese Pound	Stabilized arrangement	US Dollar	5.5	4136*	25th	91.8
Libya	LYD	Libyan Dinar	Conventional peg	Composite	6.8	6716	17th	96.1
Marshall Islands	USD	US Dollar	No separate legal tender	US Dollar	0.04	6225		
Micronesia, Federated States of	USD	US Dollar	No separate legal tender	US Dollar	0.1	3714	88th	69.3
Papua New Guinea	PGK	Kina	Stabilized arrangement		10.1	3116	60th	78.1
São Tomé and Príncipe	STN	Dobra	Conventional peg	Euro	0.2	2387	86th	69.7
Solomon Islands	SBD	Solomon Islands Dollar	Crawl-like arrangement		0.7	2205	56th	79.6
Timor-Leste	USD	US Dollar	No separate legal tender	US Dollar	1.3	2389	63rd	77.5
Tuvalu	AUD	Australian Dollar	No separate legal tender	Other	0.01	5222		
Venezuela, RB	VES / VED	Bolívar Soberano	Other managed arrangement		28.3	15976*	29th	90.5
Zimbabwe	ZWL	Zimbabwe Dollar	Other managed arrangement		16.3	1677	16th	96.9

Sources:
(i) Currency Code and Currency Name data is from SIX Financial Data Standards (2024); for Kosovo is from Central Bank of Kosovo (2024); for West Bank and Gaza (territory) from U.S. Department of State, 2023 Investment Climate Statements: West Bank and Gaza (n.d.)
(ii) Exchange Rate Classification and Exchange Rate Anchor data is from IMF Country reports
(iii) Population and GDP per capita (current USD) data is from World Bank Open Data
(iv) The rank and score of the countries on fragility is from Fragile States Index Country dashboard, 2023; Fragility State Index Ranking 2023 was not available for Kiribati, Kosovo, Marshall Islands, and Tuvalu; Data for West Bank and Gaza (territory) was listed under Palestine
Blue shading indicates countries that engage in currency substitution.