TCX Squared – Creating Currency Risk Markets to Mitigate Currency Risk at Scale

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Unhedged currency risk undermines any serious efforts to deliver SDGs and tackle climate change.

Most low and lower middle-income countries lack deep pools of domestic savings that can help finance the levels of investment spending needed for them to meet the sustainable development goals, mitigate emissions to limit global warming, and adapt to be resilient to the rising risks from climate change. Meeting these goals will require very large amounts of external funding. Without serious institutional reform, and with most external lending to these economies denominated in hard currencies, additional external debt inflows will likely triple the unhedged currency risks borne by these economies from $2 trillion to $6 trillion by 2030[1].

This unhedged currency exposure increases economic uncertainty, raises risk premiums for credit and investment, and has been the most frequent trigger for past and ongoing debt crises faced by developing economies. Unless proactively addressed by hedging at scale and other risk mitigating measures, this currency risk overhang will undermine any serious efforts to deliver the SDGs or climate mitigation and adaptation goals.

The unbearable level of currency risk is the results directly from policy and market failures.

More than 80% of lending to these economies from MDBs and DFIs is dollar denominated. This shifts the exposure to and responsibility for managing currency risk away from sophisticated treasuries of international institutions on to capacity constrained DMOs and central banks of poor economies which also cannot rely on the benefits of diversification that characterize most MDB and DFI portfolios. This practice defies the logic and spirit of the responsible lending principles that DFIs & MDBs have repeatedly committed to.

The FX market is the largest market in the world registering a daily turnover of $6.6 trillion, but is very highly concentrated in dollars, euros and a handful of other currencies belonging to rich developed economies. Over 100 low-income economies together account for less than 0.2% of all currency trading, offering little prospect for hedging. It is possible to get a price for a 10-year hedge only for eleven

[1] Authors' calculations based on part of the SDG funding gap being plugged, but mostly in hard currencies

developing economies, all of which are large, and none a low-income country. At a 3-year duration, the private market exists for around 20 developing economies.

The Bridgetown initiative has showcased that development and climate goals will fall short of the necessary financing if the international community fails to tackle currency risk at scale. However, the problem of currency risk in the financing of low-income countries has been recognized years ago in academic circles under the colorful heading "original sin". Low-income countries are penalized for not being able to borrow in their own currencies, something mostly only rich economies can do.

To address this, a group of development banks and financial institutions set up TCX in 2007 to allow these lenders to provide (synthetic) local currency loans and hedge the resulting currency risk where no commercial markets existed. Since then, TCX has been offering currency hedges in more than 100 low and lower middle-income countries having executed more than 6,000 hedging transactions worth more than $11 billion.

In the process, TCX has also demonstrated that by offering transparent and risk sensitive pricing, warehousing, risk pooling, and term-transformation functions, it can catalyze the creation and deepening of currency risk markets by attracting private risk capital. This is significant, but not yet significant enough and needs to be scaled up at great speed, to address the trillions of dollars in additional currency risk that will accompany required growth of development and climate finance absent institutional reform.

A Package of Policy Reforms to Lift Currency Risk from the Shoulders of Low-Income Borrowers

The forthcoming Summit for a New Global Financial Pact should discuss and agree on a policy reform package which include a new mandate for MDBs and DFIs to provide local currency loans, a gradual shift of donor support away from lowering funding costs in foreign hard currency loans towards lowering the costs of local currency lending, a scaling up of currency hedging markets and scaling the role of TCX as effective and crisis-tested currency risk market creation instrument.

Mitigating currency risk is a prerequisite for both climate resiliency and scaling up finance. That is why in the ongoing discussions on MDB reform, DFIs and MDBs as well as other public lenders should be asked to offer lending in local currency as the default option rather than the current practice of dollar lending, unless the lending is ringfenced for FX generating projects. Yes, this can result in a higher upfront interest burden for borrowers. But, these upfront costs will eventually be more than offset by positive effects on credit risk margins because of more stable cash flows on the micro level, improved risk transparency, better investment decisions, and the overall benefits of operating in a more stable macroeconomic environment with a lower frequency of debt distress and currency shocks.

Nevertheless, cash strapped borrowers in fragile economies may need donor financial support to defray the higher upfront costs of local currency borrowing. Blending support may prove catalytic for the private sector involvement necessary to deepen currency risk markets.

TCX Squared – a business model, governance, and track record to scale up massively.

Through centralization at TCX, currency risk in frontier and emerging markets is pooled, and benefits from scale effects in terms of diversification, market creation networks, and operations. TCX has performed robustly through tumultuous times that include the Global Financial Crisis, the taper tantrum, the Covid crisis and ongoing Fed tightening. It has generated modest profits while continuing to create and deepen currency risk markets, share knowledge, and build currency risk management capacity in an ever-expanding set of countries.[2]

TCX is perhaps best thought of as a remarkably successful pilot project that must now be scaled up. It has accumulated experience and expertise, earned credibility with donors, counterparties and rating agencies, and demonstrated a consistent track record driven by strong governance and a competent management. TCX is ready to scale, but organic growth alone through accumulated earnings, gradual addition of new shareholders, and new commitments from existing shareholders will not be able to plug the trillion-dollar hedging gap.

Scaling up TCX's capacity can happen gradually to accommodate growing hedging demand grows because of more responsible lending practices by DFIs and MDBs. To begin with, some US$ 5 billion should be added in some combination of paid-in equity capital, convertible debt and callable capital. This would allow TCX to reach an interim 2025 target of about US$60 billion in hedging capacity, an ambitious, but achievable 12-fold increase over the current $5 billion. Over the medium-term, as demand for currency risk grows, additional capital will be needed. Donor support could also take the form of SDR allocations and / **or** access to IMF SDR liquidity. As the market reaches critical size and expands in scope, it will also attract institutional investors who should find it attractive to build sizeable, diversified portfolios. This crowding in of private risk capital may eventually enable a further increase in TCX leverage in creating & deepening currency risk markets, making a $1 trillion market for hedging low-income and lower middle income countries' currencies achievable in the foreseeable future.

[2] Despite operating as a pioneer institution in risky frontier markets, TCX has been assigned a solid A rating by S&P and A1 by Moody's earning praise from both for its 1) strong governance, 2) arms-length valuation overseen by a pricing committee of independent emerging market experts, 3) prudent risk management, 4) high levels of transparency, 5) hedging offsets, 6) unique mandate, 7) strong liquidity 8) robust support from shareholders, and 9) consistent track record. It also has minimal overheads and very low operating costs.