

## **Why multilateral development banks should provide finance in domestic currencies: a growth and financial stability proposal**

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**Summary:** National banks are supposed to offer finance or capital to private and state-owned enterprises, which allows them to invest and to innovate. From this we would conclude that multilateral banks should play the same role, with the difference that its loans are usually disbursed in a reserve currency. This paper rejects that developing countries need foreign capital but acknowledges that major projects often require finance. Thus, it distinguishes, on the macroeconomic level, finance from capital. The assumption is that, to execute large investment projects, developing countries need finance, not capital; countries should not be interested in incurring in current account deficits (the so called “foreign savings”) to develop; they should grow with their own savings. The growth with foreign indebtedness policy is self-defeating in so far that the financing of account deficits leads to the appreciation of the national currency and, so, encourages consumption instead of investment. Thus, it is not on the interest of developing countries to incur in current account deficits. Nevertheless, multilateral banks may have an important role in fostering growth in developing countries if they provide finance, either if they make loans in the domestic currency of the country, or if they contribute to fund major investment projects in infrastructure and renewables.

**Key words:** finance, capital, multilateral bank, domestic and foreign money

**JEL classification:**

Economists may diverge on the conditions for economic development but there is a practical consensus that economic growth depends directly, in the short-term, from capital accumulation and innovation. Yet, investment and technical progress don't happen in the vacuum. There are some general conditions for the accumulation of capital that the state is supposed to provide. On the supply side they are: education, institutions that guarantee the working of the markets, investment in infrastructure, promotion of science and technology, and a financial system able to fund investment; on the demand side, the Keynesian macroeconomic policies aiming to neutralize the tendency to the insufficiency of demand are already part of what I call “basic economic theory” – the basic concepts and models shared by economists independently of the school of thought they are associated. New Developmentalism<sup>1</sup> proposes a second general condition of capital accumulation on the demand side: that the state guarantees to the competent business enterprises the *access* to the existing demand by adopting policies that neutralize the tendency to the cyclical and chronic overvaluation of the exchange rate. If these conditions are not satisfied, investment and savings will be limited, and developing countries will

not converge to the levels of growth of rich countries even despite the competitive advantages they might have in terms of low cost of labor and possibility of copying technology.

In any circumstance, the investment as a percent of GDP is pivotal for growth. Additionally, we know that a basic contrast between developed and developing countries is that the stock of capital per capita is much greater in the former than in the later countries. Thus, it would be straightforward to infer that capital rich countries in the North should transfer their capitals to capital poor countries or South countries. Or, in other words, that developing countries should adopt the growth with foreign savings policy: should get involved in current-account deficits originated from the investments that the companies and the state-owned enterprises are doing and get finance for them. The rationale of the World Bank or of the Inter-American Development Bank is this one. Two assumptions lie behind this policy: that developing countries face not only a shortage of savings or capital, but also of foreign currency to import capital goods. Chenery and Bruno's two gap model is the formalization of this idea.<sup>2</sup> The fact that the distinguished economist Chenery was World Bank's chief economist for many years was not a coincidence. The model was a theoretical justification of the bank. And the second, the assumption that the current-account deficit has been provoked by the supposed additional investments that countries would have performed. Both assumptions have problems: the first one is misleading, the second one, false.

MDBs have traditionally provided financing in foreign currency to their borrowers, but in the last years the alternative of lending in domestic currency began to be considered. The usual explanations for that are, first, the greater sensitivity to borrowers' currency mismatches and, second, the development of local capital markets. The New Development Bank, the bank governed by BRICS countries, spelt out the proposal to follow this line of action. Some multilateral banks, particularly the Asian Development Bank, the International Finance Corporation and even the World Bank are already lending in local currency. Why? Would it be the new concern with currency mismatches and the development of local capital markets, as suggests Tobias C. Hoschka (2005)? May be, but I believe that there are stronger reasons. I propose that the Multilateral Banks are turning to domestic currencies because their customers are most of the time private companies that resist to take loans in hard currency to avoid foreign exchange risks. Second, because after the Asian 1997 financial crisis, many countries, particularly the Asian countries, realized the financial crisis risk involved in getting indebted into foreign money and began to accumulate large international reserves. Third, because, after the disastrous attempt to grow with foreign indebtedness ("foreign savings") that the Washington Consensus proposed from the early 1990s (just after the major 1980s' foreign debt crisis was overcome), the governments of the developing countries went back to the policy of keeping the current-account balanced or with a surplus, as China has been doing for long.

My explanation for this third reason is that the countries, eventually, realized that the growth with foreign savings policy is in most cases a mistaken policy. That developing countries should have either a current-account balanced, or, if the country faces the Dutch disease,<sup>3</sup> achieve regularly a surplus proportional to the severity of the disease. I have been arguing for some time in that direction.<sup>4</sup> This is a self-defeating policy; it is the outcome of a self-deception on the part of creditors, while it is interest-laden on the part of debtors. It is self-defeating, because the chronic capital inflows in excess of capital outflows deriving from the long-term current-account deficit inevitably appreciates the national currency. It involves self-deception on the part of the creditors because they justify their indebtedness increase arguing that foreign savings will add to the domestic savings, thereafter increasing the investment ratio. Notwithstanding, in most cases we have seen a soared substitution of foreign for domestic savings, as the inflows of foreign savings will rather finance consumption than investment. It is an interest-

laden view on the part of creditors because they are interested in the short run in making the loans or the direct investments that finance the foreign deficit.

Knowledge has room to advance when it is counter-intuitive; and the critique of the growth with foreign savings policy is new and counter-intuitive. Nevertheless, economists and policy-makers have difficulty to incorporating new ideas in their way of thinking, especially if they are counter-intuitive. Foreign money will only be a lever for growth in two particular conditions: either when the country is already growing very fast, the expected rate of profits or the investments opportunities increased, the marginal propensity to consume fell, and the rate of substitution of foreign for domestic savings will fall, or whether the country has a fix exchange rate regime. But this alternative is precarious because the country will not have ability to keep the exchange rate fixed while the current-account and the foreign debt are increasing.

In other words, the new-developmental theory says is that to get indebted in foreign money is usually a bad policy. Developing countries must overcome the foreign constraint that derives from the two perverse elasticities: their import-elasticity of manufactured good above 1, and rich countries' import-elasticity of primary goods below 1. Recurring to foreign finance is not of overcoming such constraint, but a way of aggravating it; it enables the increase of consumption, not of investment; it increases the rate of growth in the very short-term, while it reduces the competitiveness of country, causes low growth, and it leads this country to cyclical financial crises, while making the country indebted for the future generations.

Developing countries must manage its exchange rate and neutralize the tendency to the cyclical and chronic overvaluation of the exchange rate caused by the Dutch disease and the practice of high interest rates to attract capitals. More than that, they must manage the five macroeconomic prices; they must keep them "right" – something that the market is unable to achieve; they must keep the interest rate low, the exchange rate competitive, the wage rate growing with productivity, and the inflation rate under control, so that the profit rate of manufacturing industry, or, more broadly, of the tradable non-commodity industry is kept satisfying, duly encouraging investment. For sure, this is a difficult task; the government does not count with all the required instruments; but one thing is sure: the market is unable to keep the five macroeconomic prices right. The existence of the central banks to manage the interest rate and the inflation rate are an acknowledgment of that. Central banks may also implement the exchange rate policy but developing countries must have a government body that defines the exchange rate policy and strives to competitive the exchange rate, balancing short and long-term national goals. A government body that would be similar to, but not the same government committee that defines the monetary policy.

Summing up, developing countries should not incur in current-account deficits because the capital inflows required to finance the deficits would permanently press the currency downwards. Now, it makes little sense to have an exchange rate policy that neutralizes the tendency to the cyclical and chronic overvaluation of the exchange rate while engaging in current-account deficits pressing the currency to make it overvalued. To reject this policy is the first thing to be done. Thus, the country should centralize the foreign financial account and keep the exchange rate reasonably under control. This is what Brazil did during the high days of its development (1930-1980); this is what the East Asian and the Southeast Asian countries do.

Thus, multilateral development banks that haven't updated their financial products and approaches with borrowers shall lost their basic reason to exist. Foreign finance does not make sense for developing countries. Most of their governments are not aware of the problem, but this is a question of time. Once they realize that foreign finance hinders instead of promoting economic growth, they will have left just one "reason" to get indebted – a bad reason: exchange rate populism. Economic populism is not only fiscal populism; is not just the politicians in

office, aiming their reelection, expending more than what the state gets in revenues; provided that the financial crisis does not trigger before the election. There is also exchange rate populism, which is worse than fiscal populism. And politicians know by experience that an overvalued currency means less inflation, higher short-term real wages, and happier electors. Thus, once the exchange rate got overvalued (and they are likely to have contributed to that), they act to avoid the required depreciation of the currency. In this way, they are protecting the acquisitive power not only of wages and salaries but also of the interests, real-state rents, and dividends received by the rentier capitalists. They are not interested in the very rich rentier capitalists, but in the partially rentier upper middle class whose members vote and are influential. And in this way, they get reelected, provided, again, that the currency crisis does not outbreak before the elections. Liberal economists, who are critical of fiscal populism (a common mistake of left populists), incur almost inevitably in exchange rate populism because they are steady sponsors of the growth with foreign savings policy.

But supposing a country that is very poor and does not have a domestic capital market to support them. What to do in order to finance large investment projects? I would suggest that the country may use foreign finance without using foreign capital; it can count with the help of the foreign agent – the multilateral bank – to be financed, without getting indebted in foreign currency. The multilateral bank will continue to be responsible for the financing of major development projects, which require a huge sum of capitals, that private banks will have difficulty in putting together or may not be interested due its long-term maturity. They have the expertise to evaluate the projects, to ask for modifications and enhancements, and the financial capacity to organize the body of creditors of the other financial institutions that will share with the multilateral bank the financing of the project.

To make loans in the local currencies involves a problem to the banks. They either will obtain resources in the local financial markets, or they will accept incurring in a currency mismatch, which is risky. The solution will be a combination of the two possibilities. Not because the countries should not incur in exchange rate risk, but because it is essential to avoid the appreciation of the national currency.

In conclusion, the companies in each developing country that use technology in the world state-of-the-arts must be competitive; being technologically and managerially competent, they must have ensured an exchange rate that guarantees their access to the existing global and domestic demand. A competitive exchange rate is one of the general conditions of capital accumulation that the capitalist state is supposed to provide. The national states cannot do this alone. The multilateral banks may actively contribute to the fulfillment of this condition if they make loans in the local currency.

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<sup>1</sup> Bresser-Pereira (2010), Bresser-Pereira, Oreiro and Marconi (2014).

<sup>2</sup> Chenery and Bruno (1962).

<sup>3</sup> Corden and Nery (1982), Bresser-Pereira (2008).

<sup>4</sup> Bresser-Pereira and Nakano (2003), Bresser-Pereira and Gala (2008), Bresser-Pereira, Araújo and Gala (2014), Bresser-Pereira (2017).