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Democratising debt
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The contemporary problem of financing economic transformation is simple. Rich, ageing populations in developed countries should be investing in poor countries that have a young workforce capable of generating higher returns to capital. If markets work, finance should flow from rich countries to poor countries.

This does not happen. The rich view poor geographies as "risky" places to do business. Hence, the international financial architecture imposes "sector" and "country" limits on such financial flows. Per capita income of a country has the largest weight in a country's risk rating — the poorer you are, the less money you get. At the project level, normative judgements of "macroeconomic and "institutional" risk generate high risk premiums on investments in developing countries. This effectively means that any project implemented in a rich country gets capital at a much cheaper cost than an identical project in a poor country. This is a sub-optimal outcome but one that rich countries were content with for the past 50 years. The negative impact of this risk mispricing was entirely felt by developing countries.

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Now, however, this mispricing has implications for the well-being of the children of rich people. Vast amounts of finance need to flow to poorer geographies to mitigate climate change. But the very architecture that facilitated the throttling of finance to developing countries is now acting as a barrier to accelerating climate investments.

Finance Summits are happening, even today, in Paris. But, setting aside the waffle and cheesy general statements by global leaders, there is no attempt to tackle the fundamental question of risk mispricing.

I have, for long, advocated action on an important obstacle to such risk reduction. India is fortunate in that our sovereign borrowing is almost entirely undertaken in Indian rupees (INR). Foreigners can buy government debt only in rupees. They are repaid in rupees, which they can then convert to dollars at the prevailing exchange rate. The only exceptions to this are the multilateral development Banks (MDBs) like the World Bank.

Unfortunately, this luxury is not available to most developing countries. Eighty per cent of their borrowing happens in foreign currency. This means when their currency depreciates (which can happen for a variety of external reasons) the cost of debt goes up. It is currency risk, not fiscal imprudence or poor economic management, that has caused almost all default or near-default situations. Avinash Persaud (*https://shorturl.at/txEL7*) shows eloquently that such risks are consistently over-estimated.

There are many proposed solutions to this problem. Sony Kapoor (*https://shorturl.at/ovDT3*) proposes a multilateral fund that provides lower-cost hedging support, building on the successful experience with TCX — an initiative that socialises risks to allow local currency debt issuances with more affordable hedges. Mr Persaud proposes something similar. He wants the MDBs to set up an agency to do this, except that it would cherry pick climate friendly projects for risk mitigation.

These proposals, though laudable, continue to subordinate developing countries to the extant balance of power. They rely on disintermediated hedging but do not require increased risk appetite from rich countries. They are likely to be offered conditional on developing countries responding to the one challenge — climate change mitigation — for which the West urgently needs developing country investments. They will control macroeconomic risk by hedging, but not address the risk mispricing that is at the heart of the problem.

Emerging economies can do a lot more to address this issue on which they have, to date, been passive bystanders. The Indian and Indonesian G20 presidencies have devoted no time or attention to the following questions: Why should MDBs pass on the entire currency risk to developing countries? Would it not be a better use of their money to take on the currency risk burden instead of making project and, even worse, good governance and institutional reform loans in foreign currency? Why should we accept the default response that this would jeopardise their triple A rating, given evidence that risk is overpriced? Lending in local currency would do more to unlock capital than all the tired tinkering with balance sheets and special drawing rights that is the focus of the current discussion.

G20 emerging economies (EMEs) can also do more in their own spheres of influence. When Sri Lanka was grappling with its debt crisis, I argued that India should take over its debt as INR debt and future Sri Lankan debt should be denominated in INR. It is gratifying to see that this has happened in some measure. African countries too could leverage their currency unions to issue local currency debt with backstopping from G20 EMEs. Something similar can also be done by Mexico and Brazil in South America. Universalising this proposal will, of course, require EMEs to be responsible with their own macroeconomic management — more India than Turkey — but there are enough prudent EMEs for this to be taken up in significant measure.

Local currency debt is key to ensuring macroeconomic stability, thereby further lowering risk. India is a shining example of this. Problems of scale can be resolved and multiple solutions contemplated. But rich countries will then, in the interest of "our common planet," have to concede power. Poverty, health, education and prosperity were not sufficiently motivating for them to do so. We shall see whether the climate finance imperative motivates the rich to act in the interests of their own children.

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