Central Bank of Peru
Centenary Conference
Session 3: Discussion “The Original Sin Redux”
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Original Sin Redux presented by Hyun Shin

- **Original Sin**: debt denominated in foreign currency
  - Devaluation boosts exports (substitution effect)
    ... but the value of foreign denominated debt rises $\Rightarrow$ bankruptcies

- **Original Sin Redux**: debt held by foreign residence
  (even if denominated in domestic currency)
  - Why? In risk-off settings, difficult to refinance/roll-over debt (provided by foreigners)

- Consistent with theoretical framework: 
  Brunnermeier and Sannikov “International Monetary Theory: A Risk Perspective”
  - Sudden stop after *loss of (local) safe asset status* - Flight-to-Safety

- Consistent with Dilemma view (Rey)
Global Financial Crisis – just avoided in March 2020

- Flight to safety in the US dollar

Fed interest rate cut and repo facility
International: Flight to Safety

- Risk-on, Risk-off Flight-to-safe asset

- Problem: Safe asset is *asymmetrically supplied* by AE

Flight-to-safety → cross-border capital flows
What’s a Safe Asset? What is its Service Flow?

\[
\frac{\mathcal{B}_t}{\mathcal{Q}_t} = E_t[P\mathcal{V}_{r**}(primary\ surpluses)] + E_t[P\mathcal{V}_{r**}(service\ flow)]
\]

Example: = 0

See Brunnermeier, Merkel, Sannikov (2020). “Debt as safe asset”
What’s a Safe Asset? What is its Service Flow?

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- Value come from re-trading
- Insures by partially completing markets
- Can be “bubbly” = fragile

![Diagram](image)
What’s a Safe Asset? What is its Service Flow?

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- Value come from re-trading
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In recessions:
- Risk is higher
  - Service flow is more valuable
  - Cash flows are lower (depends on fiscal policy)
International: Flight to Safety

- Risk-on, Risk-off Flight-to-safe asset
  - EME local safe asset competes with US Treasury

- Problem: Safe asset is *asymmetrically supplied* by AE
  - Flight-to-safety → cross-border capital flows

- At times of global crisis, issuance of new debt
  - For AE at inflated prices eases conditions
  - For EME at depressed prices worsens conditions

- Question: Who insures whom? "Poor insure rich Paradox"
  - Correct insurance only if buffer is large and debt long-term enough so that no new debt issuance needed & sell safe asset/reserves instead
US Monetary Policy Spillovers

- **MoPo spillovers to EMDC** $\Rightarrow$ Flight-to-Safety - SS (loss of (local) safe-asset status)
  \[ r^{EM} < g^{EM} \] to sustain local EMDC safe asset
  \[ r^{EM} \geq r^S \] to be attractive relative to US Treasury

- “Transitory” Gamble for US, Downside Risk for EMDC

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**Standard Mo policy**

**Gamble** for social cohesion within US

backward-looking MoPo
Long-run Solution: “Rechanneling” with GloSBies

- Address root cause: Safe asset is supplied asymmetrically

- Create globally supplied safe asset via pooling & tranching

- Expand ESBies idea for euro area to EME: “SBBS (Sovereign-Bond Backed Securities) for the world”
  Euro-nomics group 2011, 2016, 2017
International: Flight to Safety

- Risk-on, Risk-off → Flight to safe asset

- Channels back some of flight-to-safety capital flows
  fewer cross-border capital flows