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

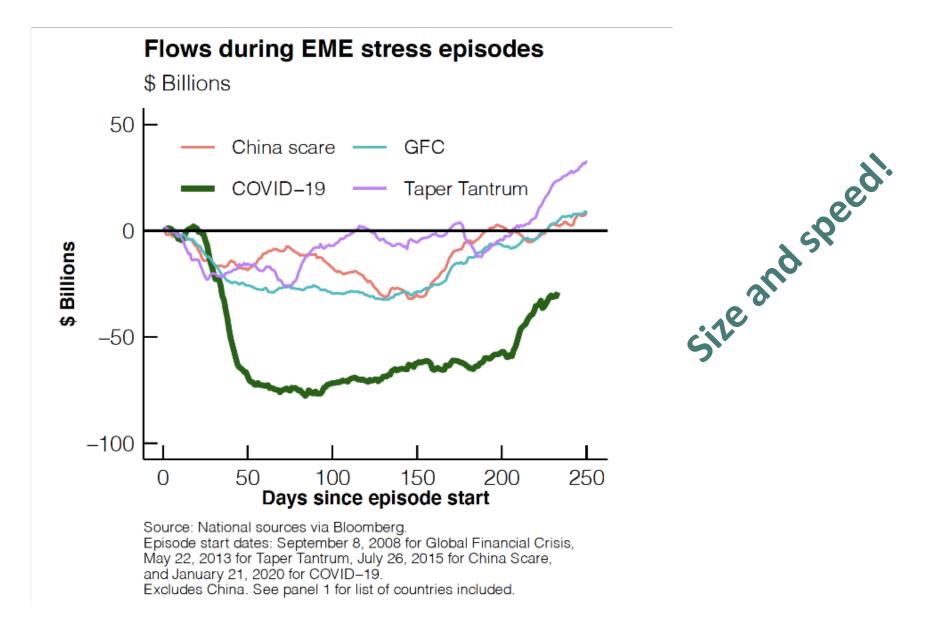
Original Sin Redux:

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

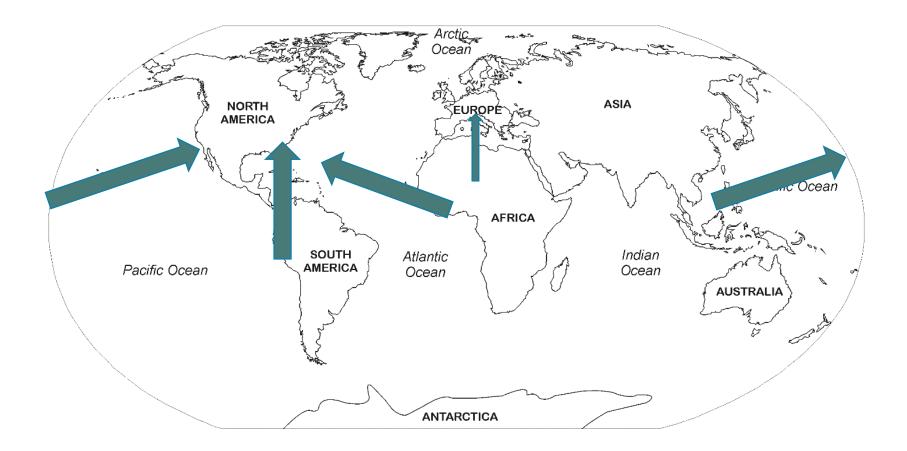


Fed interest rate cut and repo facility

International: Flight to Safety

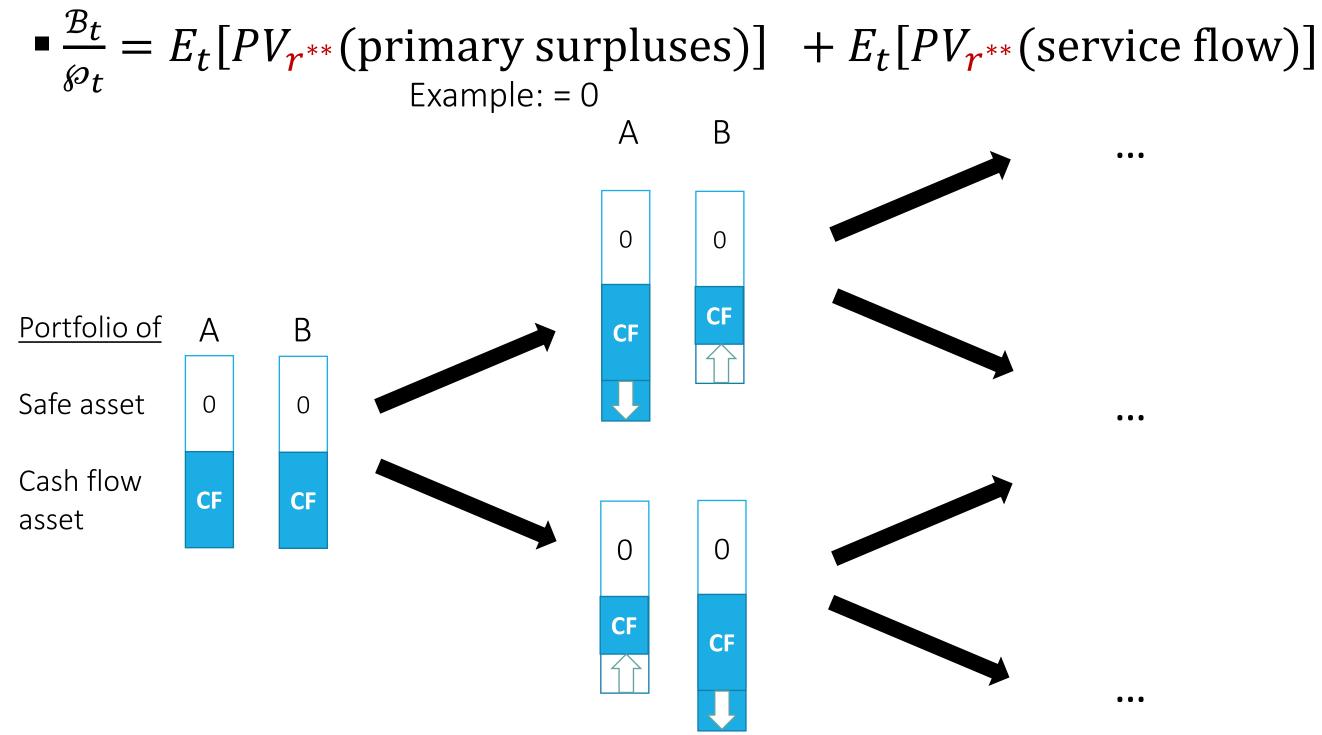
- Risk-on, Risk-off
 Flight-to-safe asset
- Problem: Safe asset is *asymmetrically supplied* by AE
 Flight-to-safety

 cross-border capital flows



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What's a Safe Asset? What is its Service Flow?

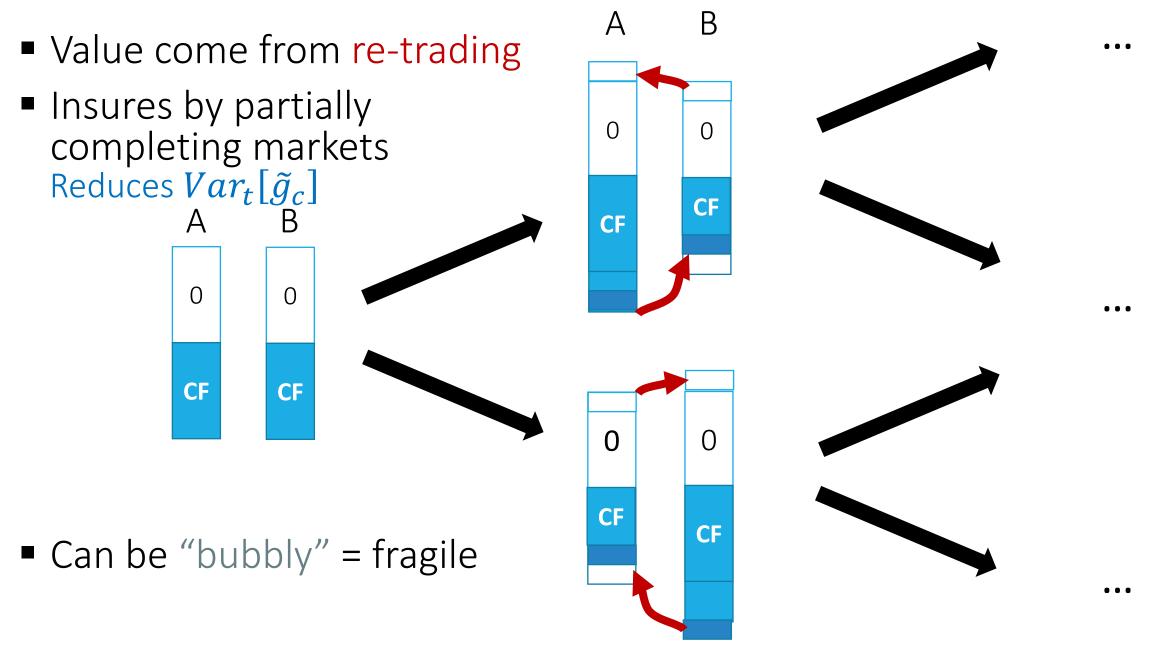


See Brunnermeier, Merkel, Sannikov (2020). "Debt as safe asset"

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What's a Safe Asset? What is its Service Flow?

 $= \frac{\mathcal{B}_t}{\mathscr{O}_t} = E_t [PV_{r^{**}}(\text{primary surpluses})] + E_t [PV_{r^{**}}(\text{service flow})]$



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What's a Safe Asset? What is its Service Flow?

• $\frac{\mathcal{B}_t}{\mathcal{D}_t} = E_t [PV_{r^{**}}(\text{primary surpluses})] + E_t [PV_{r^{**}}(\text{service flow})]$

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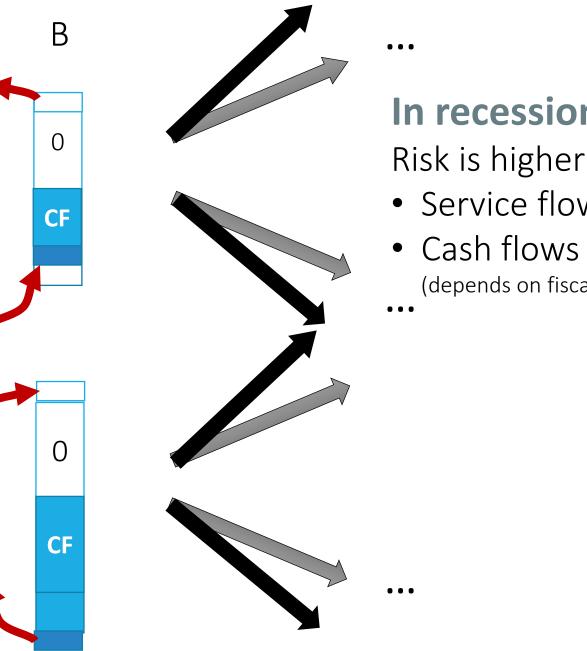
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- Value come from re-trading
- Insures by partially completing markets

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Can be "bubbly" = fragile



In recessions:

• 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
 - eases conditions For AE at inflated prices
 - 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



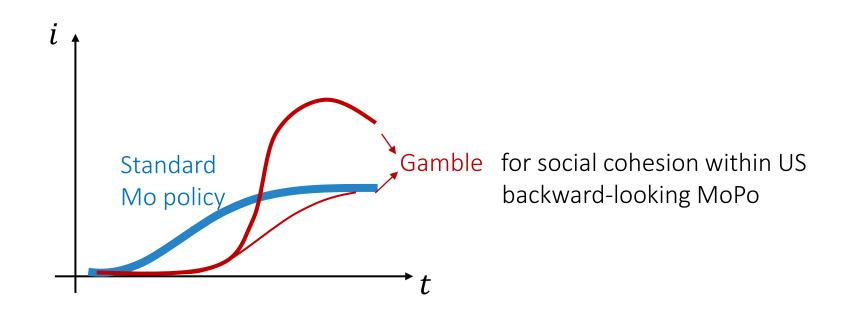
US Monetary Policy Spillovers

• MoPo spillovers to EMDC \Rightarrow Flight-to-Safety - SS (loss of (local) safe-asset status)



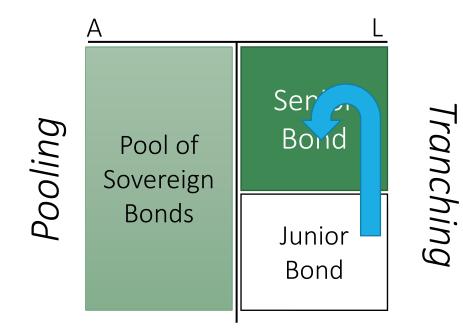
 $r^{EM} < g^{EM}$ to sustain local EMDC safe asset $r^{EM} \ge r^{\$}$ to be attractive relative to US Treasury

"Transitory" Gamble for US, Downside Risk for EMDC



Long-run Solution: "Rechanneling" with GloSBies

- Address root cause: Safe asset is supplied asymmetrically
- Create globally supplied safe asset via pooling & tranching



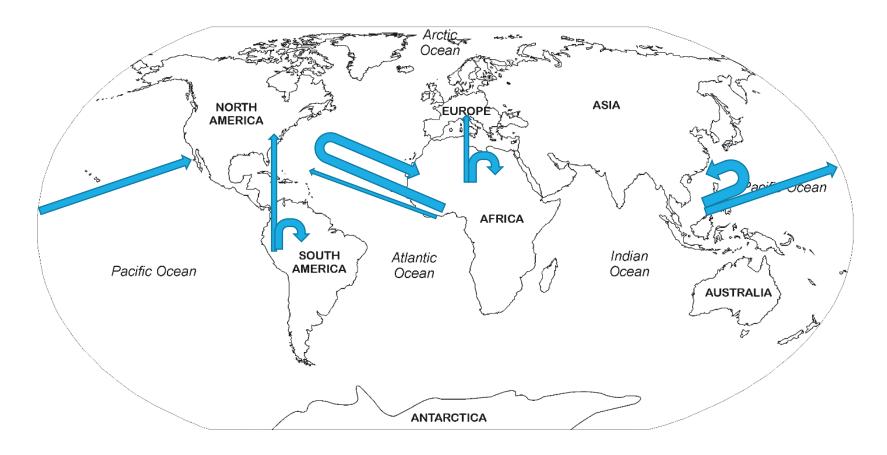
Rechannel: Instead of cross-border Across asset classes

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



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