Overcoming "Original Sin" to secure policy space

BCRP-BIS Centenary Conference

Hyun Song Shin*, Economic Adviser and Head of Research, BIS

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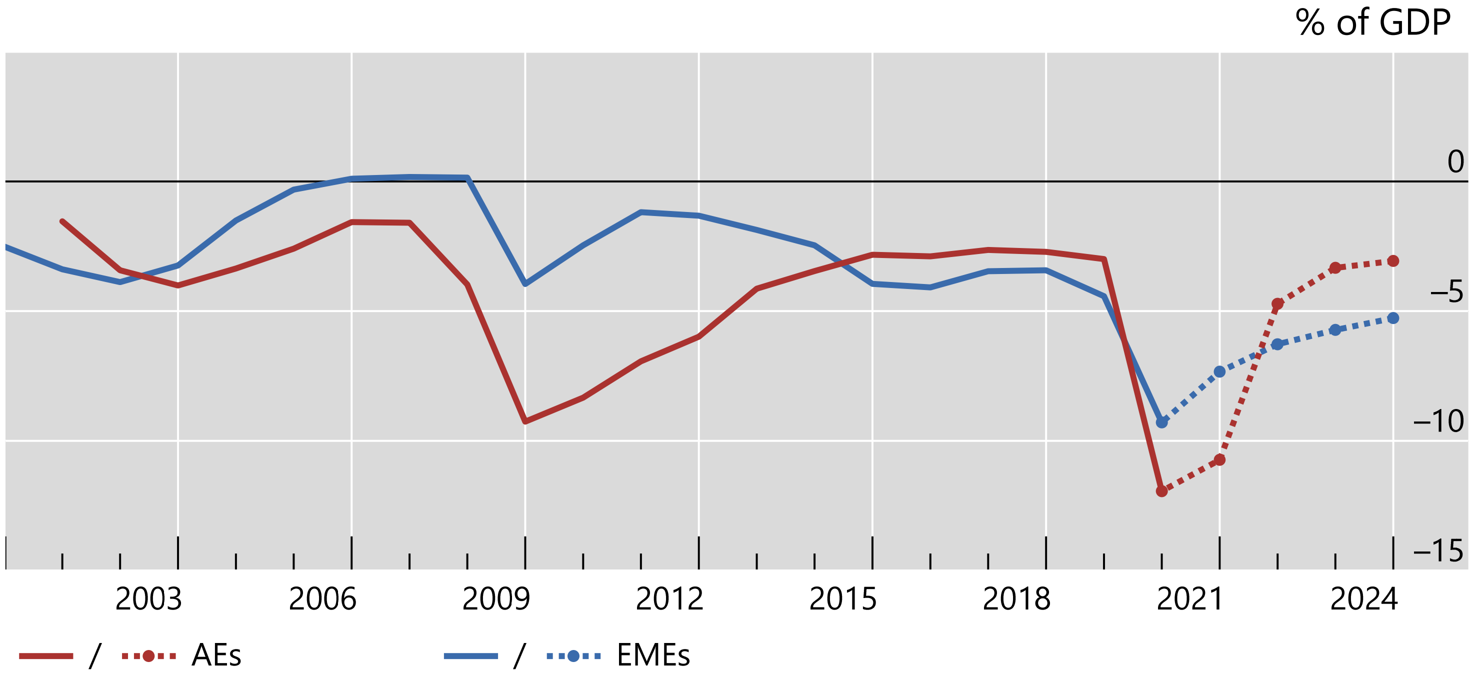
*The views expressed here are mine and not necessarily those of the Bank for International Settlements

Fiscal policy has led the way in the policy response to the pandemic, giving rise to large budget deficits, both in advanced and emerging economies

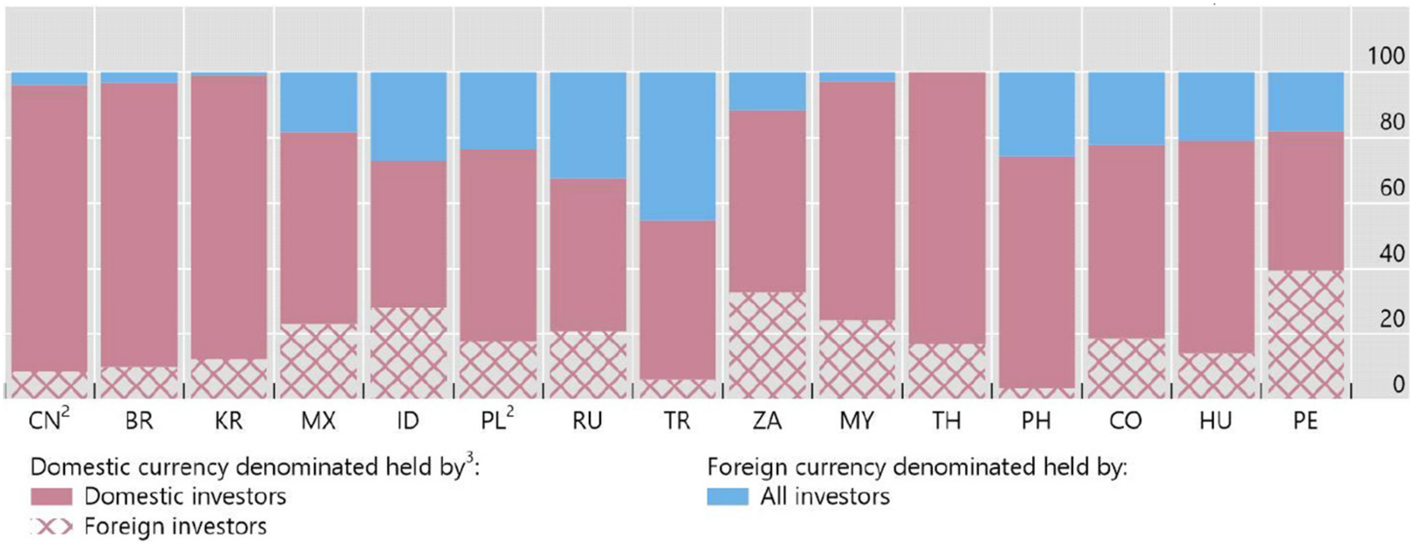


AEs = AU, CA, CH, DK, EA, GB, JP, NO, NZ, SE and US; EMEs = BR, CL, CN, CO, CZ, HK, HU, ID, IN, KR, MX, MY, PE, PH, PL, RU, SA, SG, TH, TR, TW and ZA.
Source: IMF, *World Economic Outlook*.

Most emerging market governments have overcome "Original Sin" to borrow from global investors in domestic currency

Central government debt securities[1]

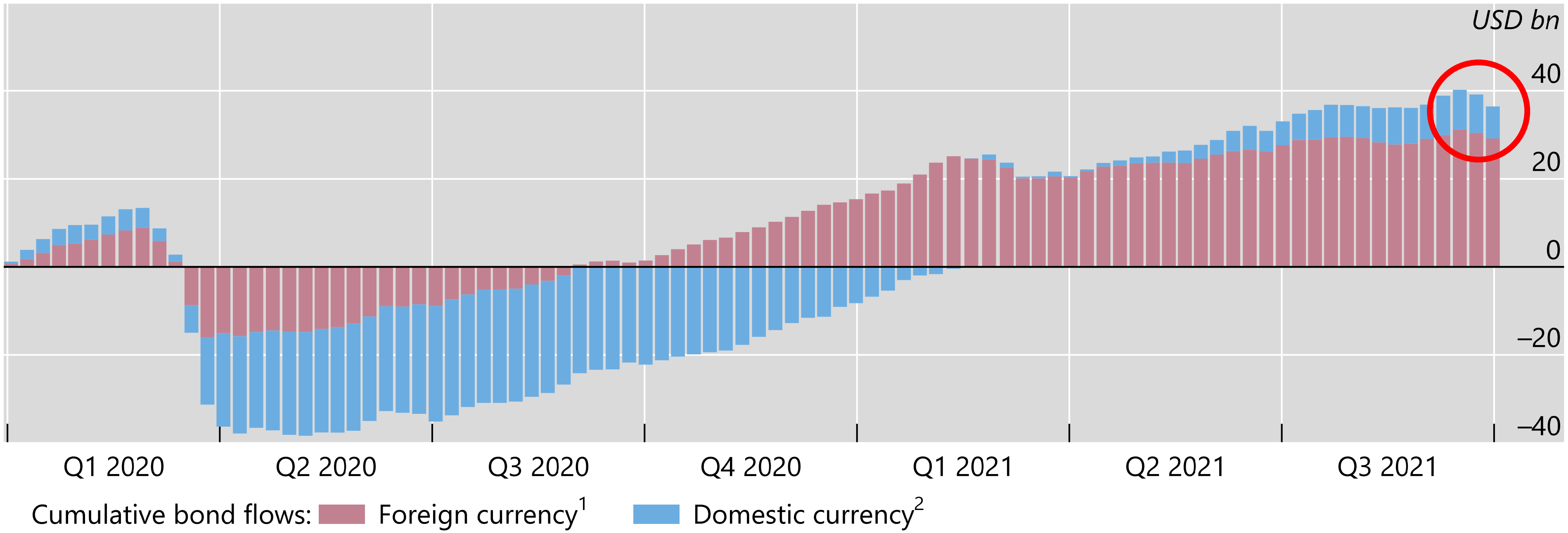
As a percentage of total amounts outstanding, at end-December 2019



[1] Issued on domestic and international markets (heterogeneous sources of data). Domestic bonds exclude money market instruments. [2] General government. [3] Breakdown by type of investor is calculated by applying quarterly estimates derived by Arslanalp et al (2014) on domestic currency denominated aggregates shown. KR is an exception, where The Bank of Korea estimates are used.

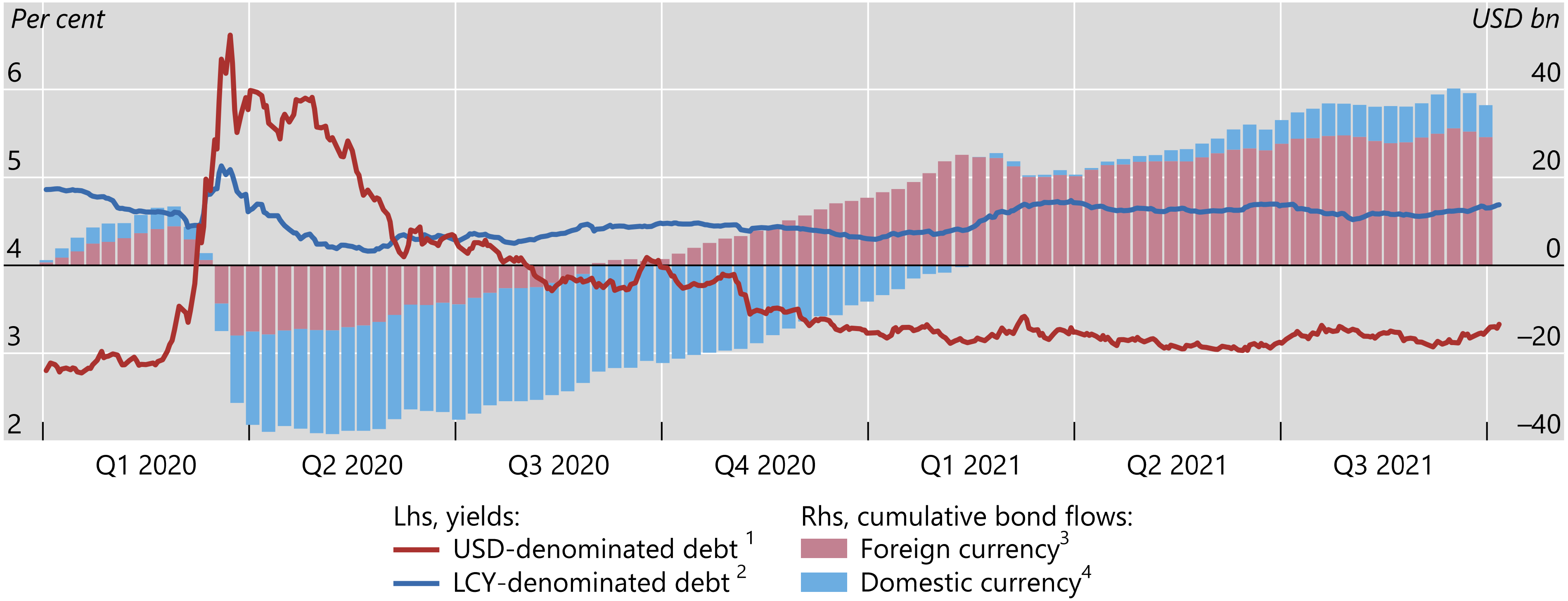
Sources: S Arslanalp and T Tsuda, "Tracking Global Demand for Emerging Market Sovereign Debt", *IMF Working Paper*, no WP/14/39, March 2014; Dealogic; Euroclear; Thomson Reuters; Xtrakter ltd; national data; BIS calculations.

But overcoming “Original Sin” has not been a panacea in securing policy space: portfolio flows in local currency sovereign bonds have barely recovered



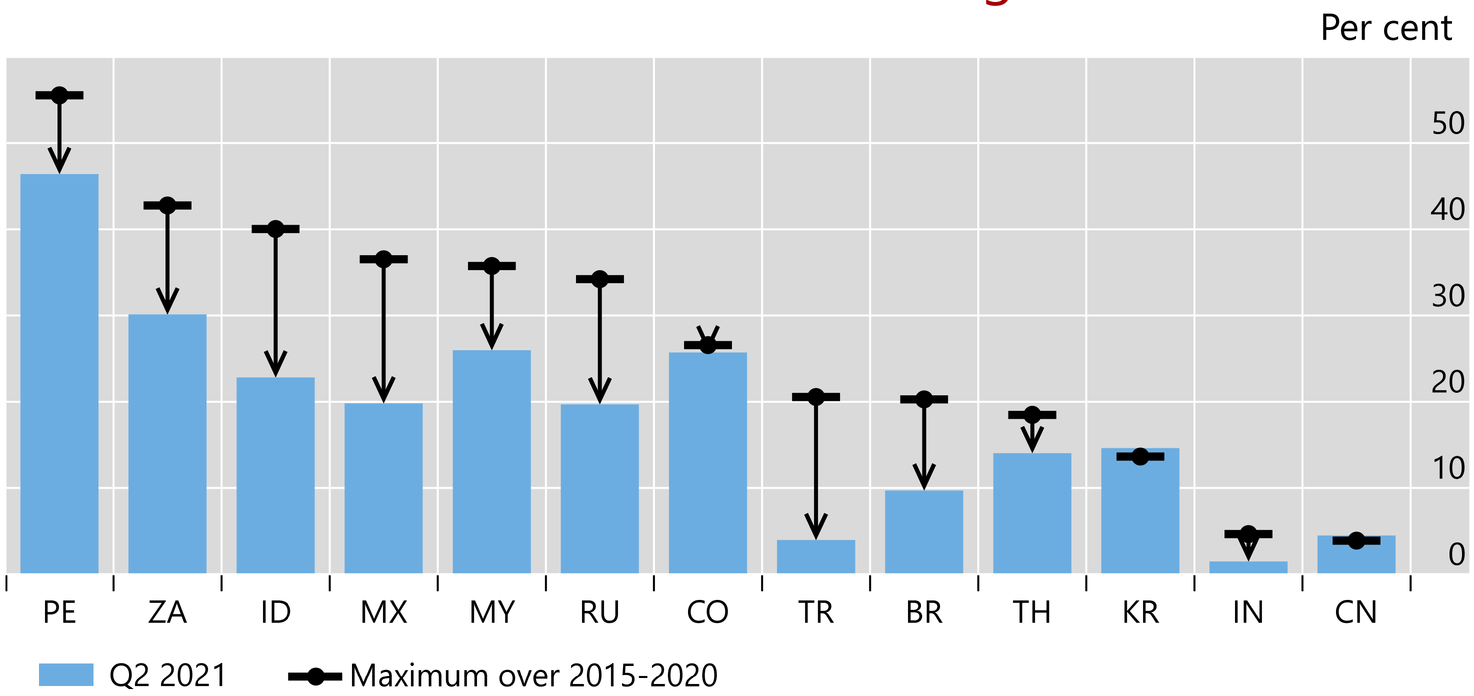
[1] Flows to foreign currency and blend bond funds. [2] Flows to local currency bond funds.
Sources: EPFR; BIS calculations.

Higher yields (in blue) reflect the higher risks in the eyes of investors, compounded by rolling social and political unrest in several EMEs



[1] JPMorgan EMBI Global index, stripped spreads. [2] JPMorgan GBI-EM Broad index, yields on traded index. [3] Flows to sovereign foreign currency bond funds. [4] Flows to sovereign local currency bond funds.
Sources: EPFR; JPMorgan Chase; BIS calculations.

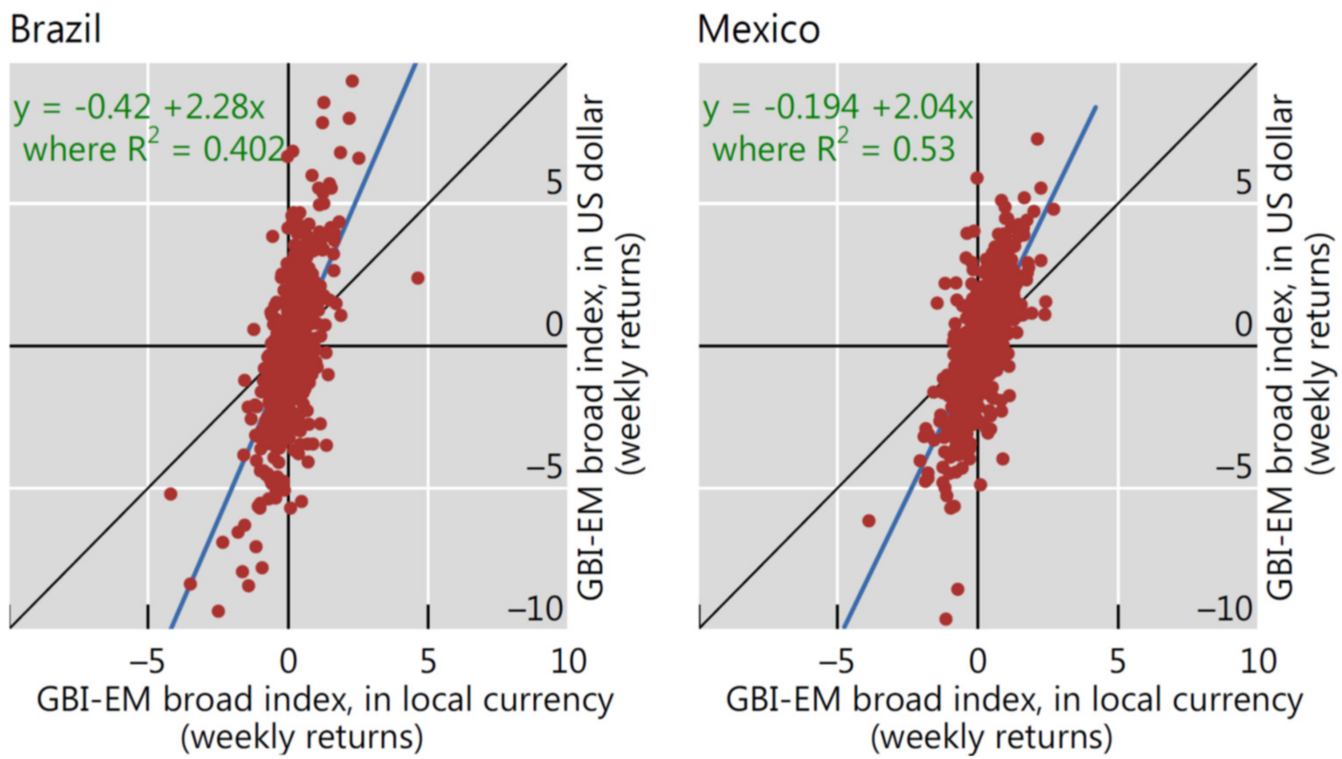
Reflecting these trends, the share of domestic currency sovereign bonds held by foreign investors has fallen relative to recent highs



Source: Institute of International Finance.

"Original Sin" has given way to "Original Sin Redux"

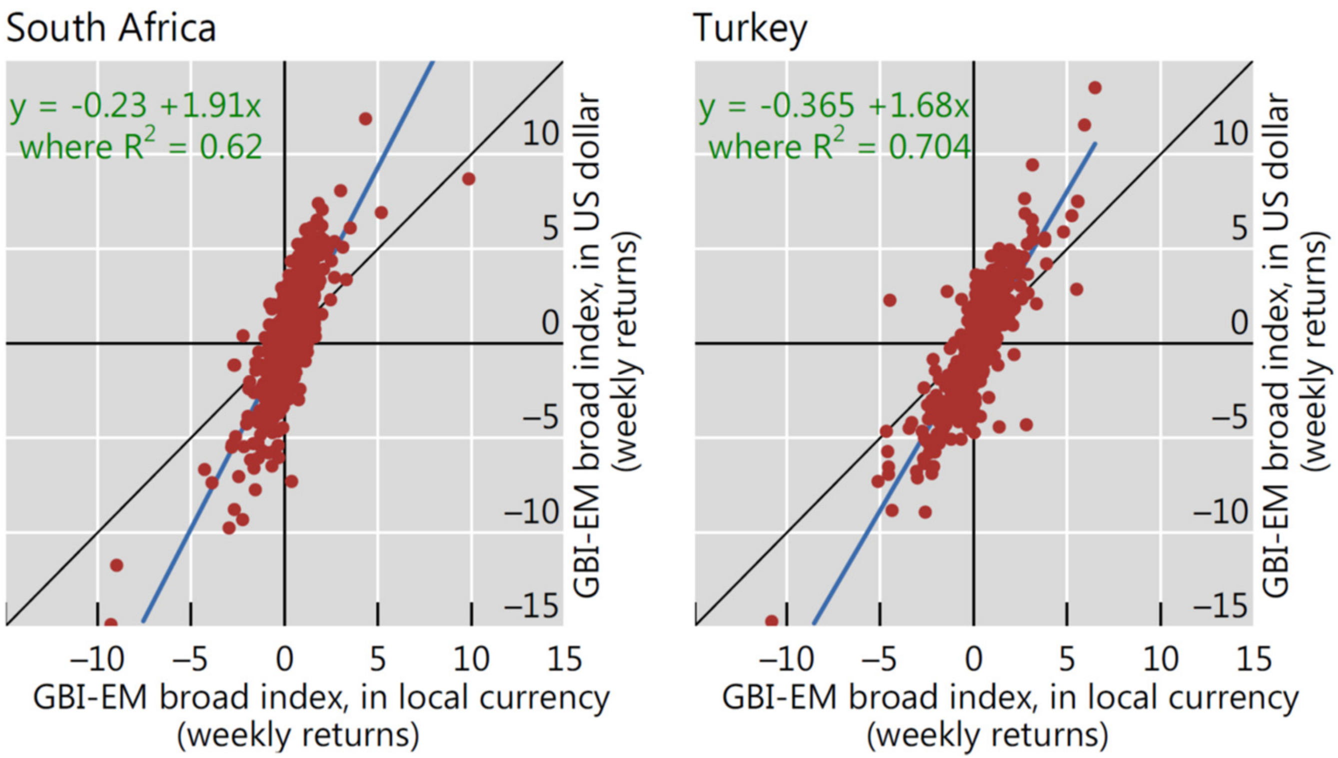
Currency mismatch has migrated from borrowers to investors, giving rise to "risk-on, risk-off" and high duration multiplier



H_0: $\beta = 1$; t-value: BR: 11.35; t-value: MX: 13.35

Sample period: weekly data from Jan 2010 to Aug 2021

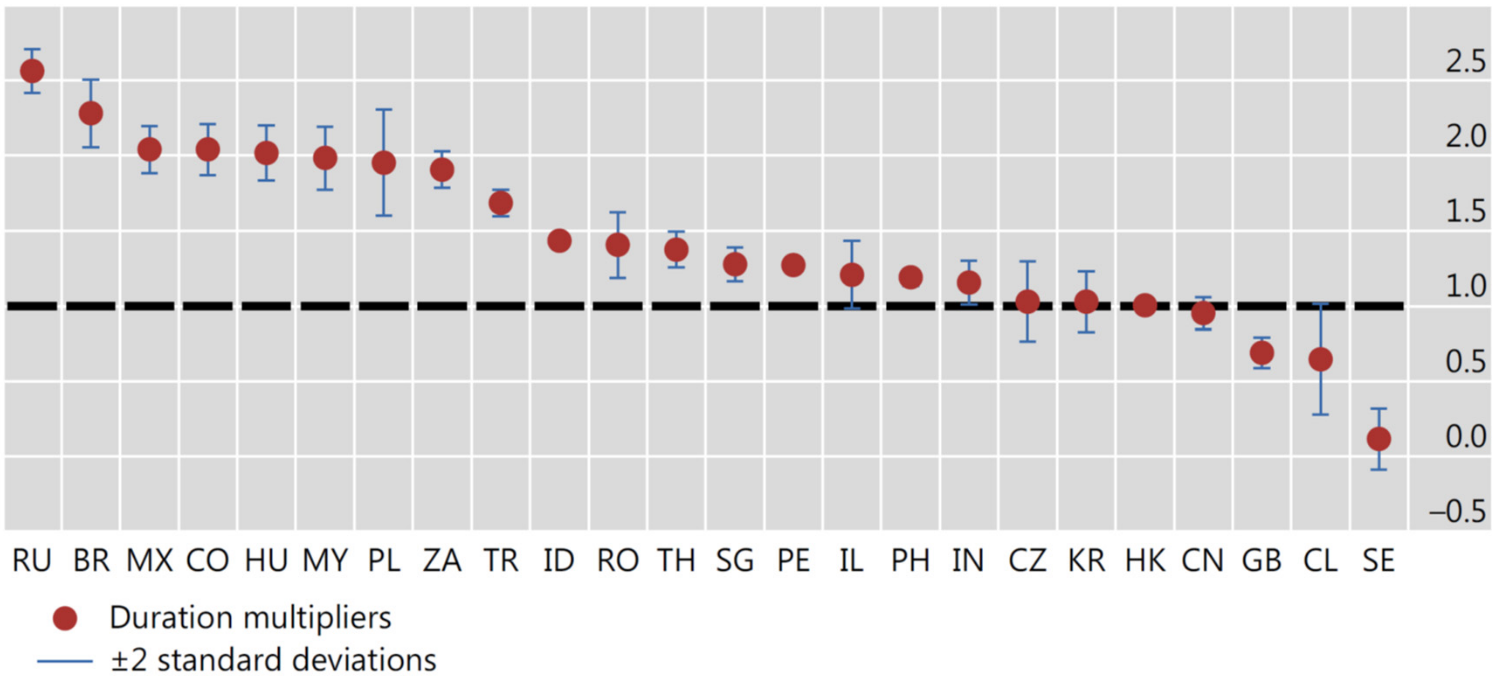
Duration multipliers tend to be well above 1 for some large EME borrowers



H_0: $\beta = 1$

t-value: ZA: 14.96; t-value: TR: 15.45

Duration multipliers for local currency gov't bonds[1]



[1] Slope of the fitted line for the US dollar returns on EME local currency government bonds against local currency returns.

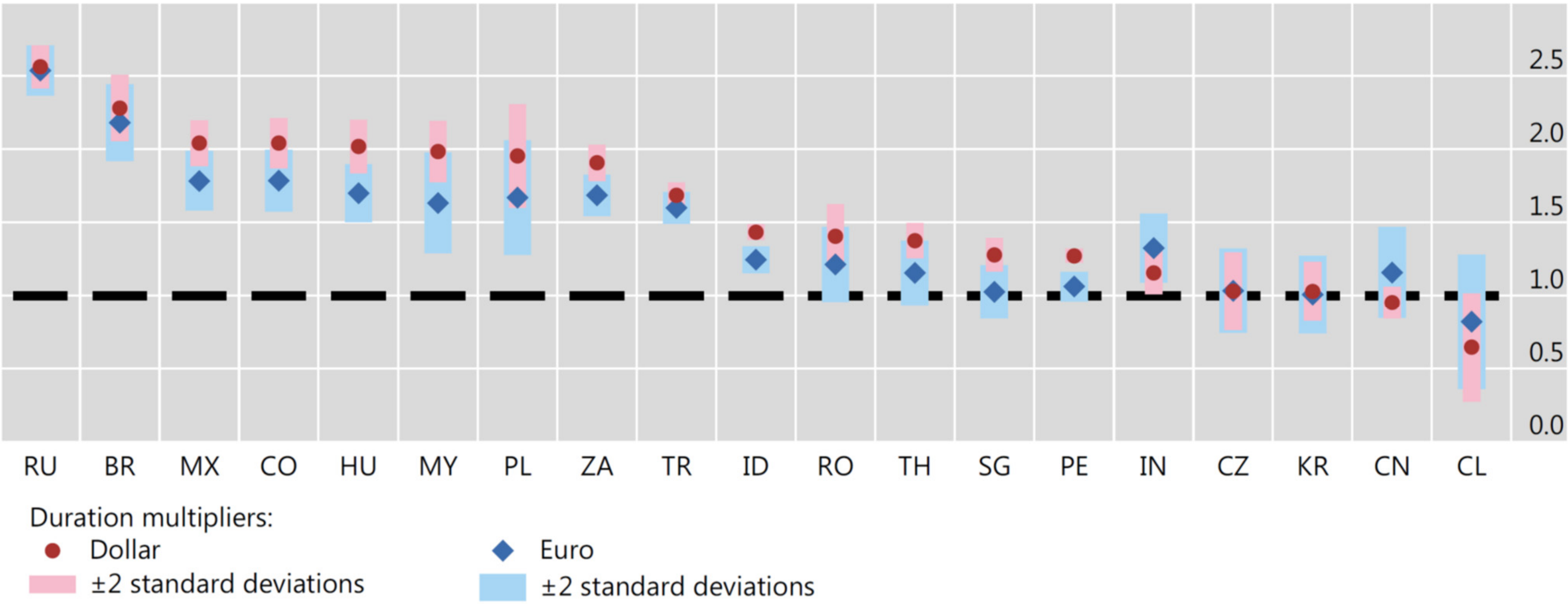
Sources: JPMorgan Chase; BIS.

Mitigating Original Sin Redux through capital market development

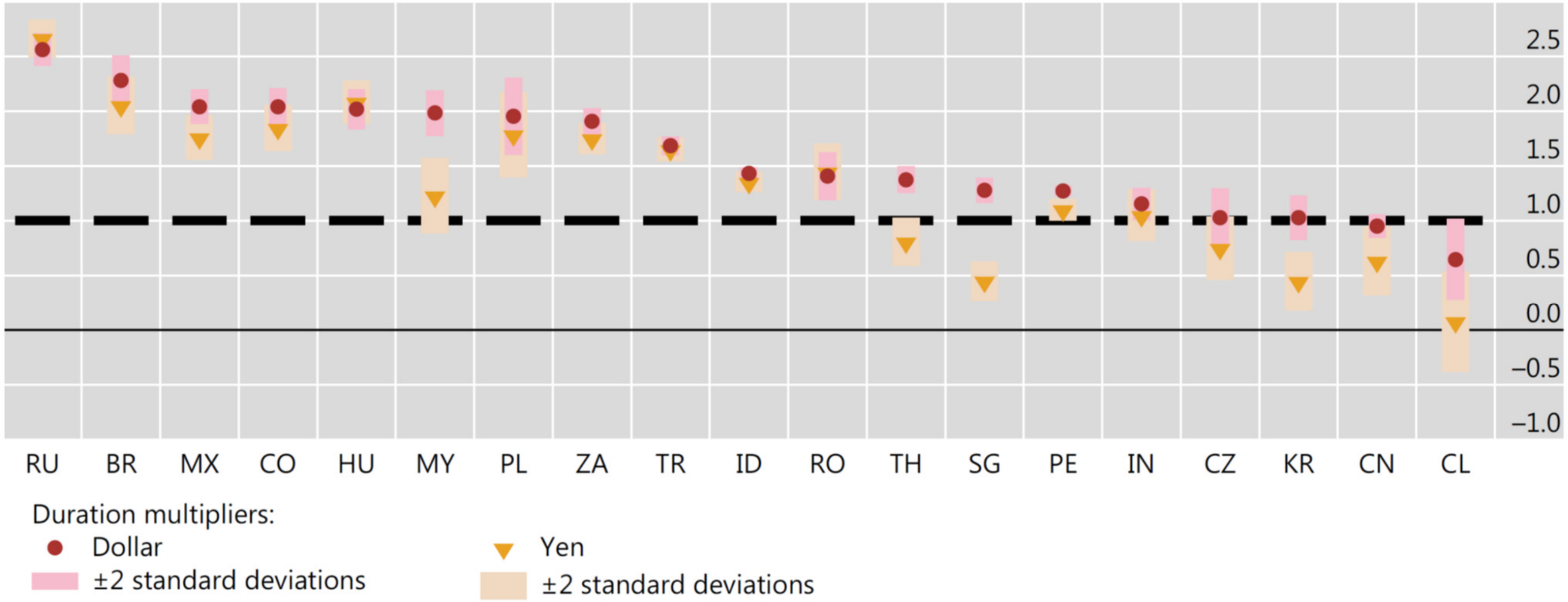
- On the part of the borrower:
  - Developing domestic investor base (eg, funded pensions, life insurers)
  - Hedging markets and associated infrastructure

- On the part of the investors:
  - Investment benchmarks and funds denominated in the home currencies of investors

Dollar and euro duration multipliers



Dollar and yen duration multipliers



Sterling and dollar duration multipliers