Central Bank of Peru Centenary Conference

Session 3: Discussion “The Original Sin Redux”

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2022-03-25

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 ⇒ bankruptcies

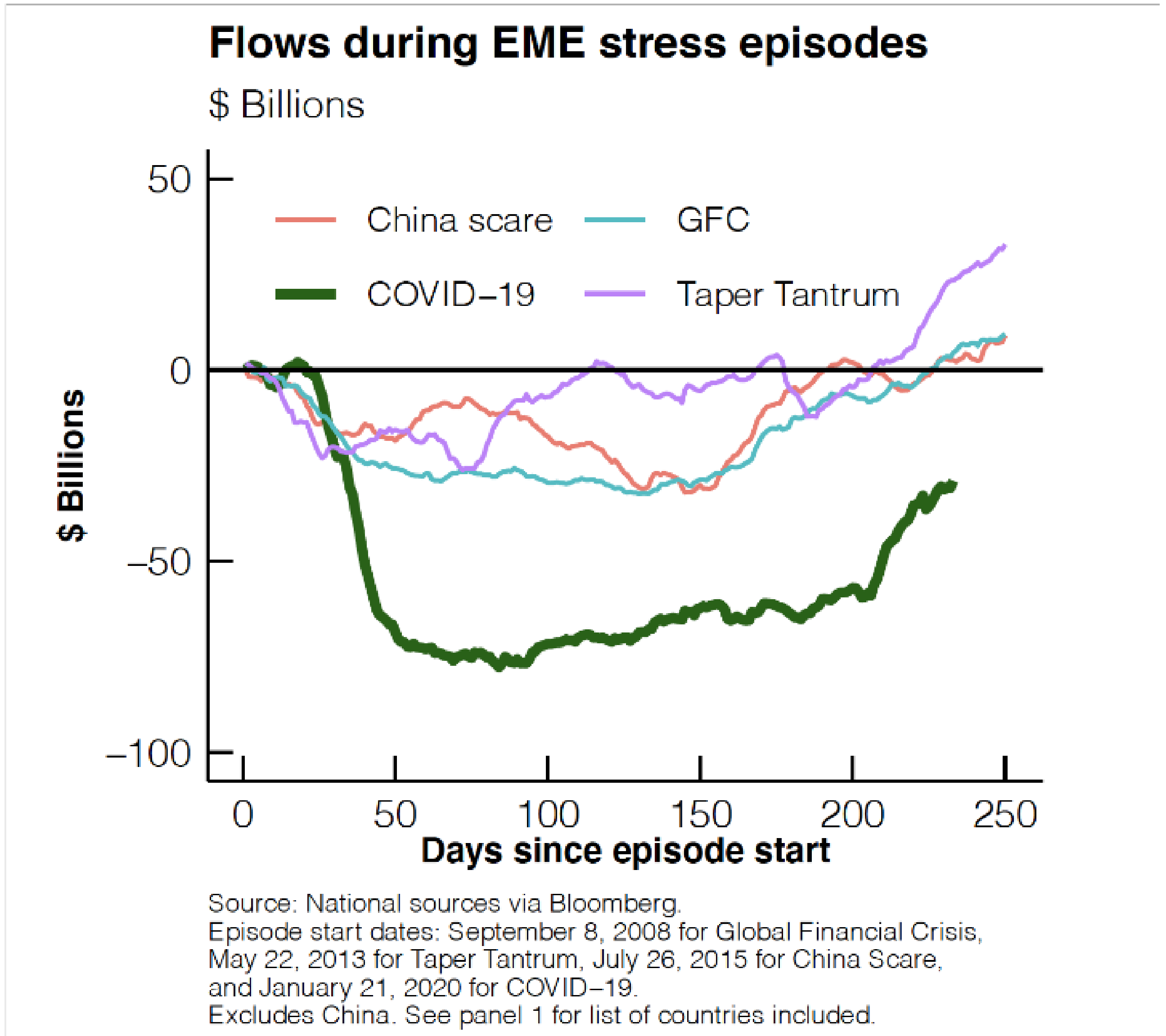
- **Original Sin Redux:** debt held by foreign residence
  (even if denominated in domestic currency)
  - Why? In risk-off settings, difficult to refinance/roll-over debt (provided by foreigners)

  - 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



Size and speed!

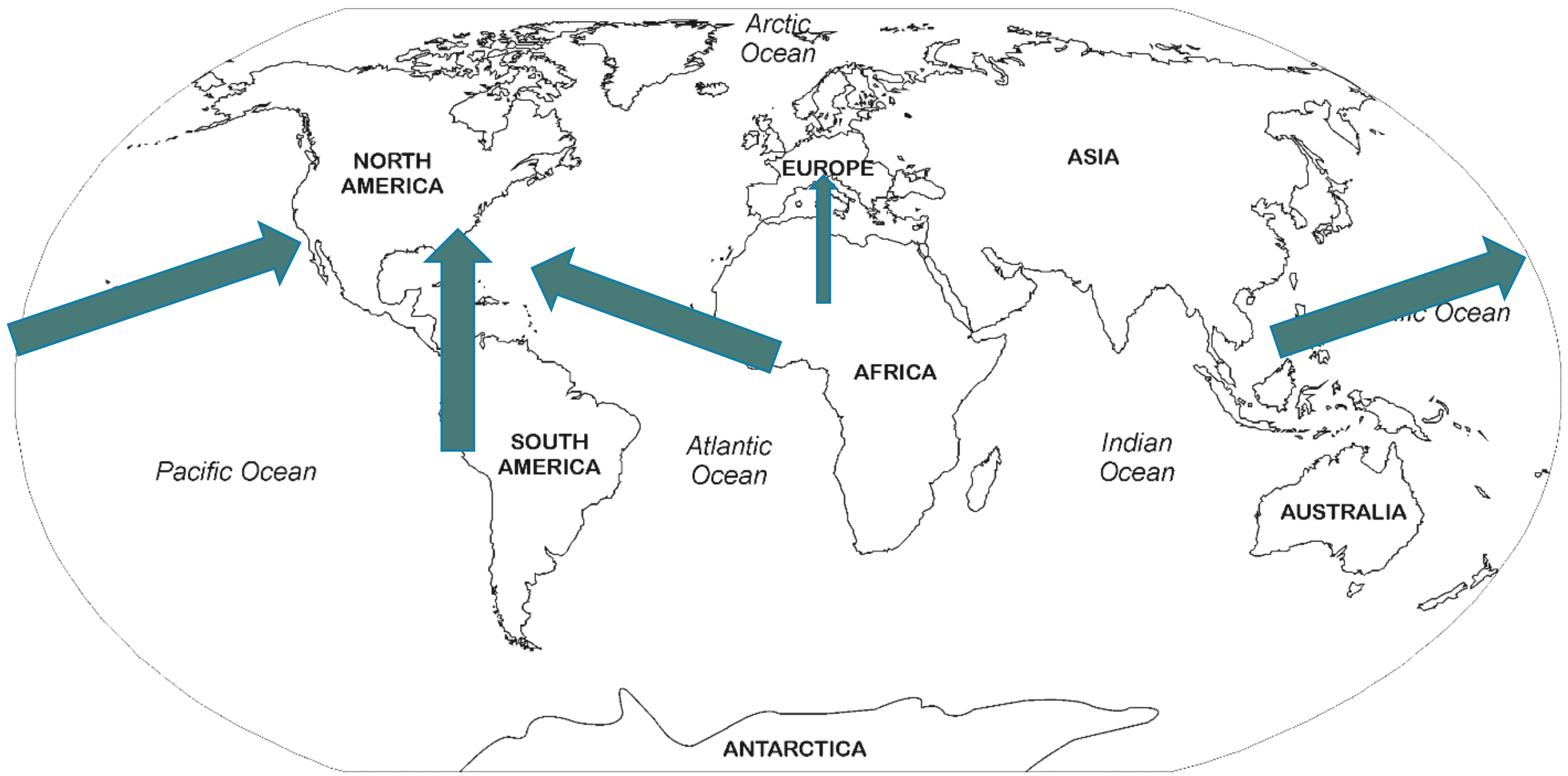
- Fed interest rate cut and repo facility

International: Flight to Safety

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

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

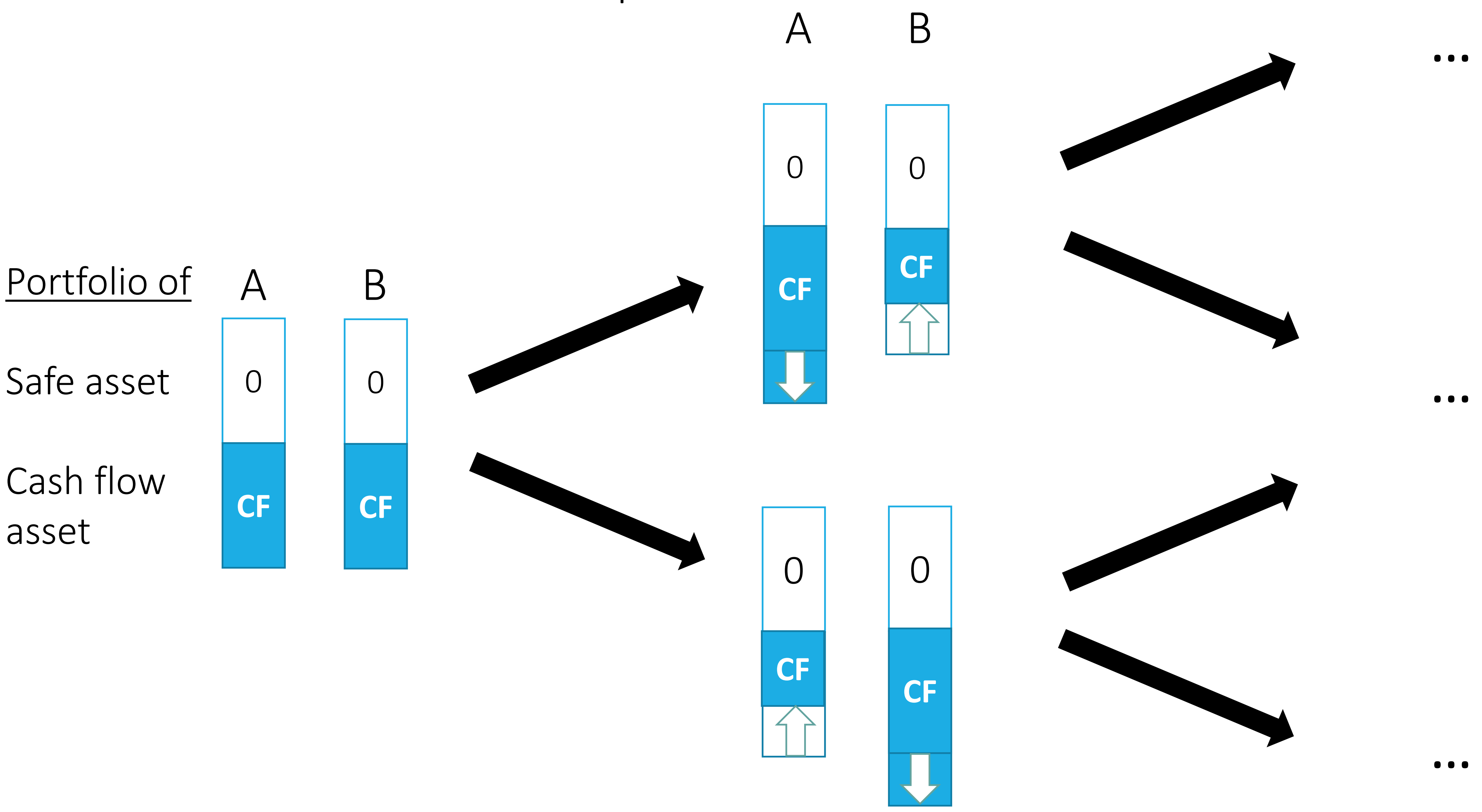
  Flight-to-safety ➡ cross-border capital flows



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

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

Example: = 0



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

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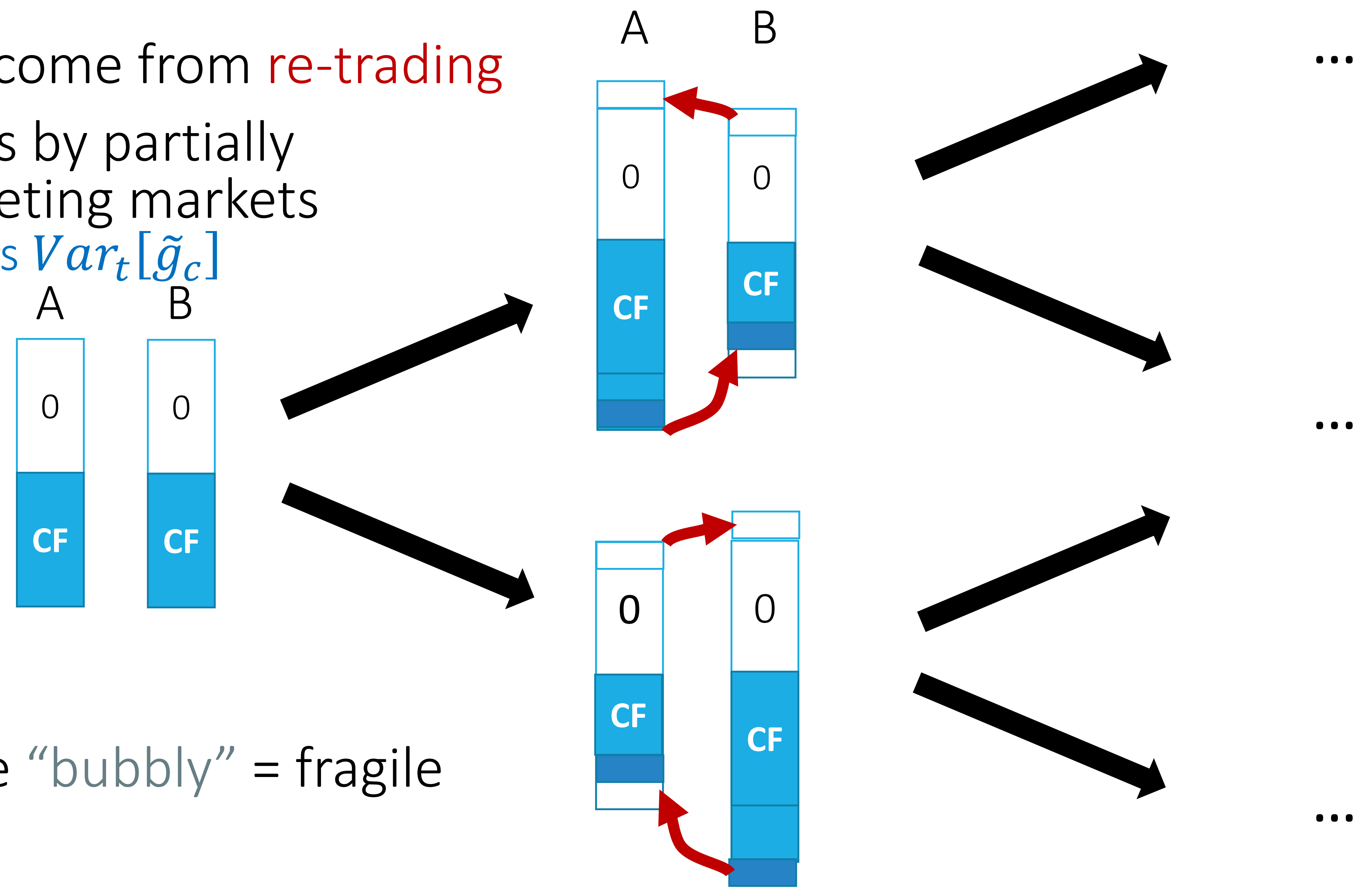
- Value come from re-trading
- Insures by partially completing markets
  Reduces $Var_t[\tilde{g}_c]$



- Can be "bubbly" = fragile

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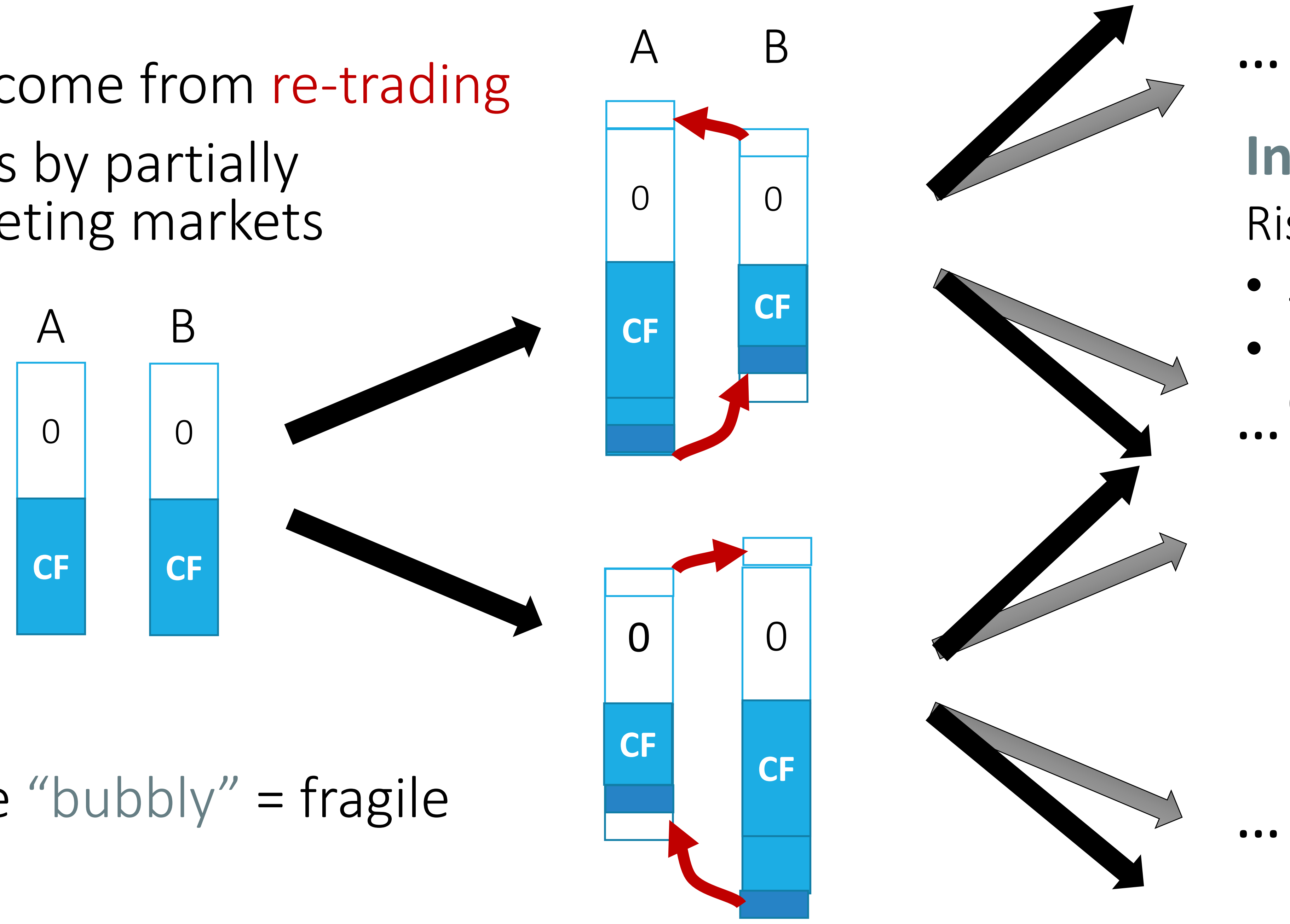


In recessions:

Risk is higher

- Service flow is more valuable
- Cash flows are lower
(depends on fiscal policy)

- Can be "bubbly" = fragile

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

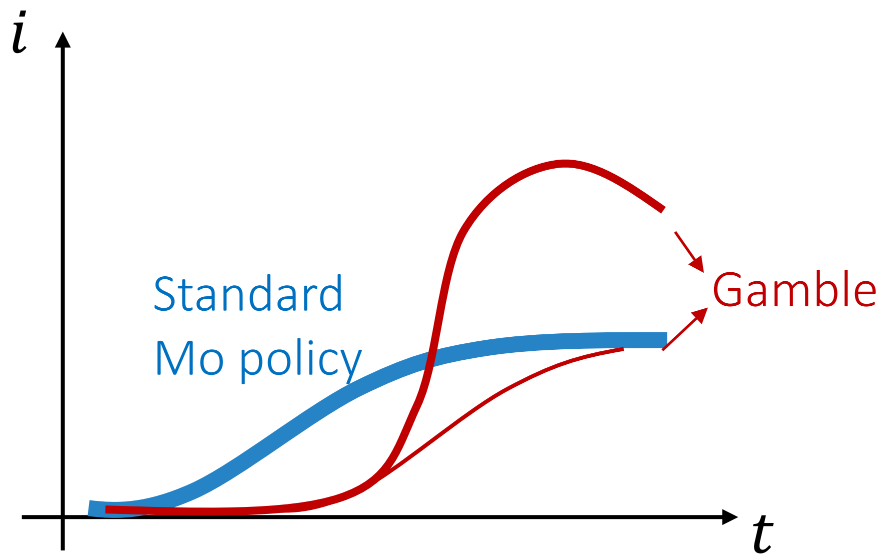
US Monetary Policy Spillovers

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

$r^{EM} < g^{EM} \Downarrow$ to sustain local EMDC safe asset

$r^{EM} \Uparrow \geq r^{\$} \Uparrow$ to be attractive relative to US Treasury

- "Transitory" Gamble for US, Downside Risk for EMDC

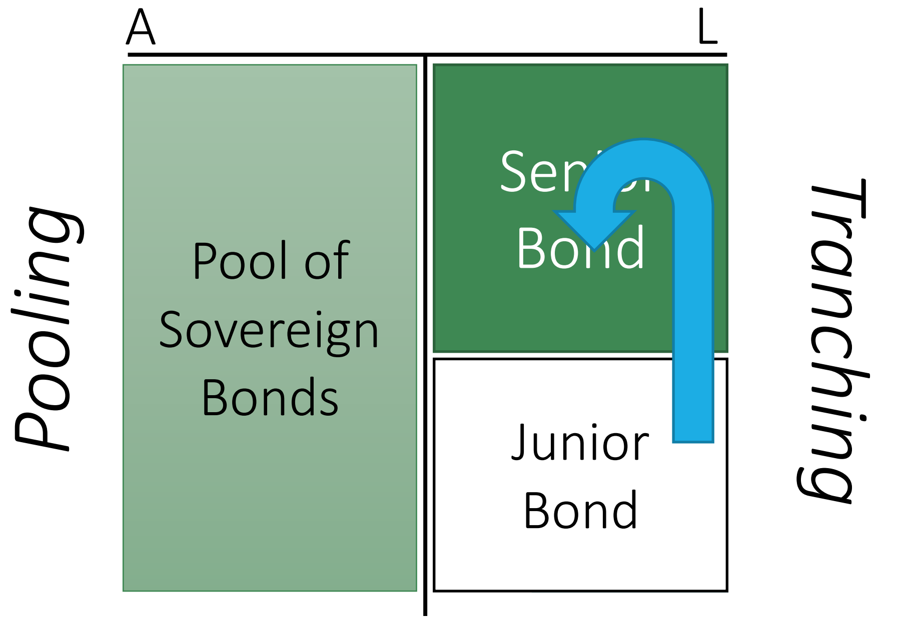


for social cohesion within US
backward-looking MoPo

Long-run Solution: "Rechanneling" with GloSBies

- Address root cause: Safe asset is supplied asymmetrically

- Create globally supplied safe asset via pooling & tranching



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