Good Housekeeping? Reputation, Fixed Exchange Rates, and the ‘Original Sin’ Problem

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Summary

A feature of the sovereign bonds issued by emerging market countries on the global capital market is that they are largely denominated in foreign currency terms. The inability to borrow internationally (and long term) in domestic currency exposes these economies to currency mismatches that exacerbate financial instability.

This paper argues that the credibility of monetary institutions is a key factor in the development of domestic debt markets. A history of high inflation and depreciation is an important reason why creditors may be unwilling to lend in a unit that the borrower can manipulate. As such, reputation in one sphere of policy (monetary framework) can spill over to other spheres (capital market access). We develop a formal model to show how monetary policy reputation influences a country’s ability to borrow internationally in domestic currency.

A key finding of the paper is that ‘original sin’ – the inflationary track record of one’s predecessors – can reverberate over time leading creditors to be wary about extending sovereign loans in domestic currency terms. Since the track record of the policymaker is imperfectly observable, his incentive to manage the exchange rate depends on his past behaviour and his predecessors’ as well. This creates incentives for policymakers to fix the exchange rate to build a reputation for financial probity and to distinguish themselves from opportunistic types who manipulate the exchange rate. The complementarity between the past and present behaviour of policymakers generates hysterisis in the updating behaviour of creditors. It makes them wary of lending money to emerging market countries in domestic currency terms. As a result, domestic capital markets may be slow to develop.

The theoretical analysis of the paper is used to examine the currency composition of debt and the choice of exchange rate regime in Japan and Russia at the turn of the nineteenth century.