An international solution to financial fragility
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Despite the best efforts of the international financial architects, the problem of emerging market crises will not go away. Most recently, the mere fact that it is a healthy democracy left Brazil between a rock and a hard place. Investors uncertain about the next president's policies sold off the *real*, causing the exchange rate to plummet. Since much of the country's debt was denominated in foreign currency, this produced a massive increase in debt-servicing costs. And given that much of the rest of the debt was short term, defending the exchange rate with interest rate increases was no solution.

The essential source of this vulnerability is that Brazil cannot borrow abroad in its own currency. Had doing so been possible, the main effect of sales of the *real* would have been more competitive Brazilian exports, not alarming increases in debt servicing costs. The crisis would have then solved itself.

It is not as if Brazilian officials are ignorant of the advantages of domestic-currency-denominated debt. Their problem is that the markets offer only one choice when they seek to borrow abroad, namely, borrowing in foreign currency.

Some would say that countries like Brazil cannot borrow abroad in their own currencies because their policies and institutions lack credibility. But this inability is not peculiar to developing countries with weak policies and institutions. In fact it affects virtually all countries aside from the issuers of the 5 major currencies: the US dollar, the euro, the yen, the pound sterling and the Swiss franc. It is not a disease limited to the macroeconomic and institutionally dysfunctional: it is also a problem for countries with low inflation, balanced budgets, strong contract enforcement, and reliable rule of law. Since it is not clear what countries have done to bring this problem upon themselves, it is referred to as "original sin."

A few statistics illustrate the point. While the major financial centers issued only 34 percent of the total debt outstanding in 1993-1998, debt denominated in their currencies amounted to fully 68 percent of that total. In contrast, while other developed countries ex-Euroland issued fully 14 percent of total world debt, less than 5 percent of debt issued in the world was denominated in their own currencies. Developing countries accounted for 10 percent of the debt but less than one per cent of the currency denomination. This, in a nutshell, is the problem of original sin.

What accounts for the concentration of the world's portfolio in a few currencies? For countries to be able to borrow abroad in local currency, the foreign investor – the proverbial Belgian dentist – must take the long position in local currency. But it is hard to imagine the dentist managing a portfolio that includes the currencies of many small economies. While each additional currency adds an opportunity for diversification, it also adds costs and risks. The optimal portfolio will therefore have a limited number of currencies.

Countries consequently face an uphill battle when seeking to add their currencies to the global basket. Moreover, each country that wins this battle will make it harder for its competitors: investors will have even less appetite for additional exotic currencies.

Thus, the problem of original sin is not merely a problem of national policies. It is a problem with the operation of the international system. Solving it requires an international initiative, not merely more preaching to the effect that emerging markets must strengthen their policies and institutions.

We therefore propose the creation of a unit of account – the EM index – based on a diversified set of emerging-market and developing-country currencies. This unit will represent claims on a more diversified economy and hence will be more stable, since shocks like changes in export prices that are positive for some economies will be negative for others. To deal with the incentive to debase the currency faced by net debtors in local currency, the unit should be indexed to the consumer price level of each country. Historically, this unit has excellent risk diversification properties for developed country investors: low volatility, trend appreciation, and a negative correlation with private consumption their own countries.

The World Bank and the other international financial institutions should immediately start issuing debt in the EM index. Their AAA rating allows them to access institutional investors. A concerted push by the IFIs could stimulate the development of a market with sufficient liquidity to make the bonds easily tradable.

The IFIs will find it easy to get rid of the currency mismatch caused by issuing EM-indexed bonds. They can simply convert the dollar loans they have made to the countries in the index into local currency CPI-indexed loans. They will thereby eliminate the currency mismatch that they generate through their own lending, thus becoming a solution instead of a cause of original sin.

If this effort succeeds in creating space in the global portfolio for EM-indexed debt, other high-grade non-residents will be able to develop the market further. The governments of the U.S., Euroland, Japan, the UK and Switzerland are the natural candidates to issue additional high-grade EM-indexed debt. They too are low-risk, AAA-rated borrowers. And they have an interest in eliminating the global instability created by original sin.

Of course, the industrial countries will not want to expose themselves to a currency mismatch. They will want to swap their currency exposure with the emerging markets. But, precisely by doing so, they will allow the EMs to offload their currency risk. In fact, this is how a few lucky countries like Poland, the Czech Republic, South Africa and New Zealand have been able to escape original sin -- through high-grade foreigners, mainly IFIs, issuing debt in their currencies and then swapping the obligations with local borrowers.

Once there exists a liquid market, institutional investors and mutual funds will attempt to create products that add credit risk to the index. They will be able to do so by buying local currency debt of the countries in the index. This will facilitate the development of these markets, further helping to erode original sin. Once the market has developed enough, the role of industrial country governments and international institutions can be scaled back, just as has happened with the issuance of individual exotic currency debt.

Original sin will not go away anytime soon as a result of the application the standard recipe of macroeconomic prudence and institution building. The only practical way for countries representing over 90 percent of the population and GDP of the developing world to be redeemed from it is an international initiative to develop an EM index market.

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