



Dangers from currency-debt nexus

Overcoming 'original sin' can rebound on debtors

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Currency wars, the fate of the euro, internationalisation of the renminbi, currency manipulation – exchange rates are at the centre of international economic controversies. No wonder: currency movements have powerful effects, and exchange rate policy is inherently political.

Whether currencies are fixed or floating, strong or weak, is subject to all manner of political pressures. Exchange rates are also central to the complex debt dynamics of today's international finance. Currency movements can cause debt crises, just as debt problems can cause currency crises.

Driving forces

These 'twin crises' are not new – there were plenty in the nineteenth and early twentieth centuries – but the forces that drive them have changed. Traditionally, currency values have mattered primarily as they change relative prices of domestic and foreign goods, hence incentives to produce, or to consume, local and foreign goods and services. But today currency values are particularly important for their impact on the relative prices of assets and liabilities.

Generations of debtors have been bankrupted by a depreciation that raised the real cost of foreign currency liabilities. This was abundantly true of the developing country debt crisis of early 1980s, as massive devaluations ruined debtors around the world.

The same dynamic was at play in Mexico's 'tequila crisis' of 1994, in the 1997-98 Asian financial crisis – indeed, in virtually all emerging market debt crises. These experiences led to the conclusion that a central problem of emerging markets was 'original sin', the inability of governments to borrow long-term in their own currency. This left emerging market sovereigns subject to currency mismatches in a world of volatile exchange rates. But even as the

'original sin' hypothesis was widely accepted, reality began to change. Starting around 2000, emerging market governments found foreign investors increasingly willing to hold local currency-denominated government debt.

As Wenxin Du of the Federal Reserve Board and Jesse Schreger of Harvard University showed in their December 2014 report 'Sovereign Risk, Currency Risk and Corporate Balance Sheets', in 14 major emerging market economies, the share of government debt in local currency held by foreigners went from 12% in 2003 to 58% in 2012.

The proportions vary: local currency foreign-owned debt of the Colombian government was 15% of the total, while for Thailand the share was 98% in 2012. But overall most of these countries' \$1tn in sovereign debt owed to foreigners was in local currency. They had apparently been absolved of original sin.

Liability mismatches persist, but now they are largely in the private sector. While emerging market governments owe well more than \$1tn abroad, most of it in local currency, emerging market private corporations owe over \$2tn to foreigners – and 90% of this is in foreign currency.

This leaves the typical emerging market acutely exposed to currency movements that can dramatically increase the private sector's debt burden. This exposure in turn can hamstring national policy. While the ideal response to a terms-of-trade or other negative shock might be to loosen monetary policy and depreciate the currency, if households or corporations are heavily indebted (and, as is typical, unhedged) in foreign currency, the government may come under major pressures to avoid a depreciation.

This dynamic was on display in eastern Europe in 2008-10. In the Baltic states, some 80% of bank loans were in foreign currency – mostly mortgages – which made it politically

virtually impossible to contemplate a depreciation, desirable as that might have been.

In Poland, where the proportion of bank loans in foreign currency was under a third, there were few political barriers to depreciating its currency by 40% when the crisis hit. This meant that Poland avoided a recession, in contrast to a GDP fall of 20% in the Baltic states.

Hungary went in a different direction. With most of its mortgages denominated in Swiss francs, the Hungarian government effectively bailed out households and pushed the losses onto creditor banks, most of which were foreign-owned.

Real economy

There are good reasons for exchange rates to move, especially to reflect trends in the real economy. But most governments must now be sensitive to the impact of currency movements on the balance sheets of both the public and private sectors. A depreciation that is eminently justifiable on macroeconomic grounds can cause major, countervailing financial disruptions. And emerging market currencies can be buffeted by other forces – such as expectations of policy changes in the major financial centres – that threaten the solvency of important segments of the local economy.

Two of the central features of today's international economy are global financial integration and exchange rate volatility. These can interact to provoke and magnify debt problems, especially in the emerging markets.

Without more systematic international macroeconomic policy coordination – which is unlikely in the near future – the dangerous nexus between international currency movements and international debts will continue. ■

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