Abstract

In the past, borrowing in foreign currency induced a large currency mismatch on emerging economies’ balance sheets, which brought financial instability and economic crisis. Nonetheless, emerging market sovereigns still borrow a substantial amount in foreign currency. In fact, emerging market sovereigns borrow even more in foreign currency when the exchange rate (FX) volatility is higher, precisely the time when it is riskier for them to do so. This paper argues that emerging economies choose to bear exchange rate risk by borrowing in foreign currency because international investors charge a high FX risk premium on emerging market local currency debt. Moreover, the required premium on local currency debt is higher when FX volatility increases, dissuading emerging economies even more from borrowing in local currency. This paper builds a quantitative model with risk-averse international investors and a risk-averse sovereign, where currency mismatch on lenders is a key determinant of FX risk premium; relative borrowing cost in local currency over foreign currency; currency composition of external public debt; the fluctuations in the currency composition with FX volatility. A counter-factual exercise shows that currency mismatch incurs a welfare cost to the emerging market sovereign of 0.35% as measured in consumption equivalents.

JEL classification: F3, F31, F34

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