

Promoting the International Use of Emerging Country Currencies:

The Case of Local Currency Debt Issuance for Latin America and the Caribbean

Andrew Powell¹
Inter-American Development Bank
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Introduction

There are many dimensions to the international use of a nation's currency. These include the use of a currency for trade invoicing and settlement, the use of a currency to denominate assets to be held as a store of value for example as Central Bank reserves and the use of a currency to denominate liabilities such as loans or bonds².

The focus of this paper is on this latter role, and more precisely the value of being able to issue debt externally in one's own local currency and the paper considers in particular the countries of Latin America and the Caribbean - LAC. In this sense this paper is related to a recent literature on what has been termed original sin³. It is argued below that being able to issue external debt in domestic currency is valuable principally for risk sharing motives and that while some LAC economies have indeed been able to issue in local currencies abroad the amounts remain relatively modest.

In order to understand the reasons why this may be the case, it is important to consider the currency composition of global currency markets more generally. Global spot and derivative trading remain dominated by a few currencies and in particular by the US dollar. This implies that dollar bond issues enjoy attractive rates for liquidity motives while countries that may wish to issue in their own rather illiquid currencies may be faced with large liquidity premia. This means that policy makers in those currencies may continue to issue external debt in US dollars and a few other currencies further exacerbating these liquidity effects.

¹ Author is the Principal Advisor in the Research Department, IADB. All view expressed are those of the author and are not necessarily the views of the Inter- American Development Bank, its Directors or the Countries they represent. I would like to thank Pilar Tavella for Research Assistance and Julian Caballero for manipulation of some of the Dealogic data. I would also like to thank Julian Caballero, Claudia Franco, Ugo Panniza and Pilar Tavella for very useful discussions. All mistakes remain my own. Comments welcome.

² See for example Kenan (2009)

³ See for example, Eichengreen and Hausmann (2003) , and Hausmann and Panizza (2003, 2010).

The following section of this paper details the composition of global currency markets and the composition of global debt issuance using a detailed database and with a focus on Latin America and the Caribbean. Section 3 then considers the value of being able to issue external debt in one's own currency. Section 4 then moves on to consider potential solutions. In particular the diversification benefits of a portfolio of currencies, including LAC and BRIC currencies is considered. These diversification benefits imply that there is an advantage to global coordination and some preliminary ideas are discussed. Section 5 concludes with a brief summary of the arguments presented and a further policy discussion.

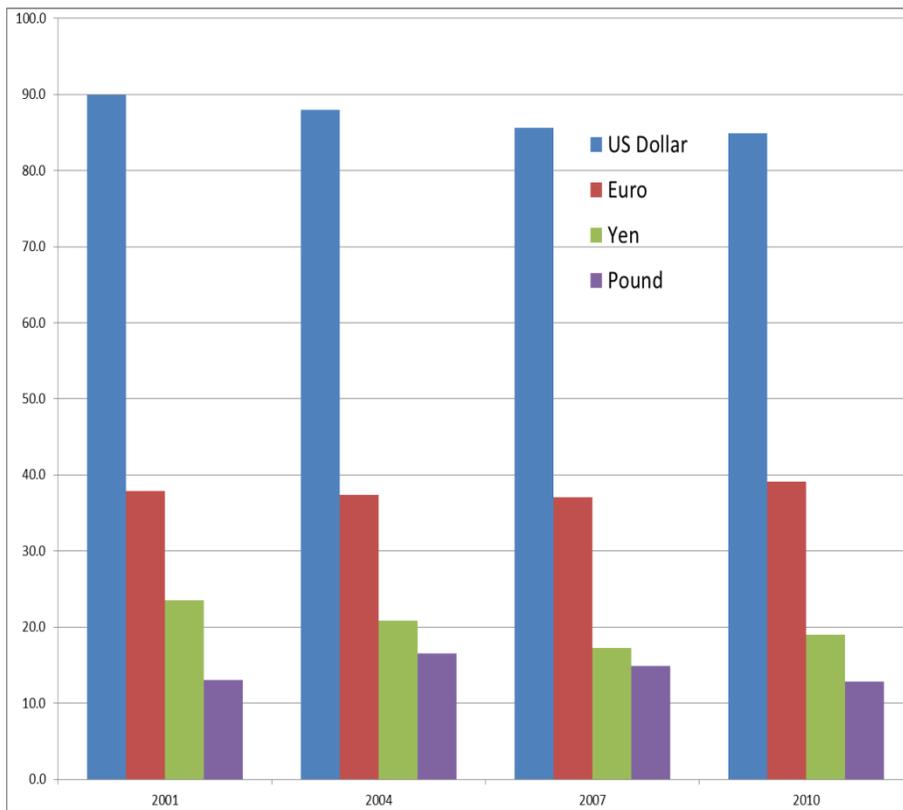
International Currency Composition of Trading and Debt Issuance in Emerging and Latin American Currencies, Selected Facts

One of the most notable features of the use of international currencies has been the relatively stable share in foreign exchange trading of the top currencies. Figure 1 plots the shares of the US dollar, Euro, Yen and Pound since 2001⁴. The dollar's share has hovered between 84% and 89% over that period while the Euro had a share of 38% in 2001, and despite much speculation regarding the eventual popularity of the new currency, this only rose to 39% by 2010, with the Yen and the Pound some way back with, again, relatively stable shares of 19% and 13% respectively⁵. Given the Yen and the Pound's one third of the market this can hardly be described as a duopoly, but the dominance of these currencies in international trading is marked and outstrips the relative shares of the four currencies in many other markets.

⁴ Data comes from the BIS triannual survey. Shares add to 200%. Data is average daily turnover in April of each year.

⁵ Indeed considering the data of 1998, the shares of the currencies making up the Euro appeared to have a total share of greater than that of the Euro although much of that may have been trading within those currencies.

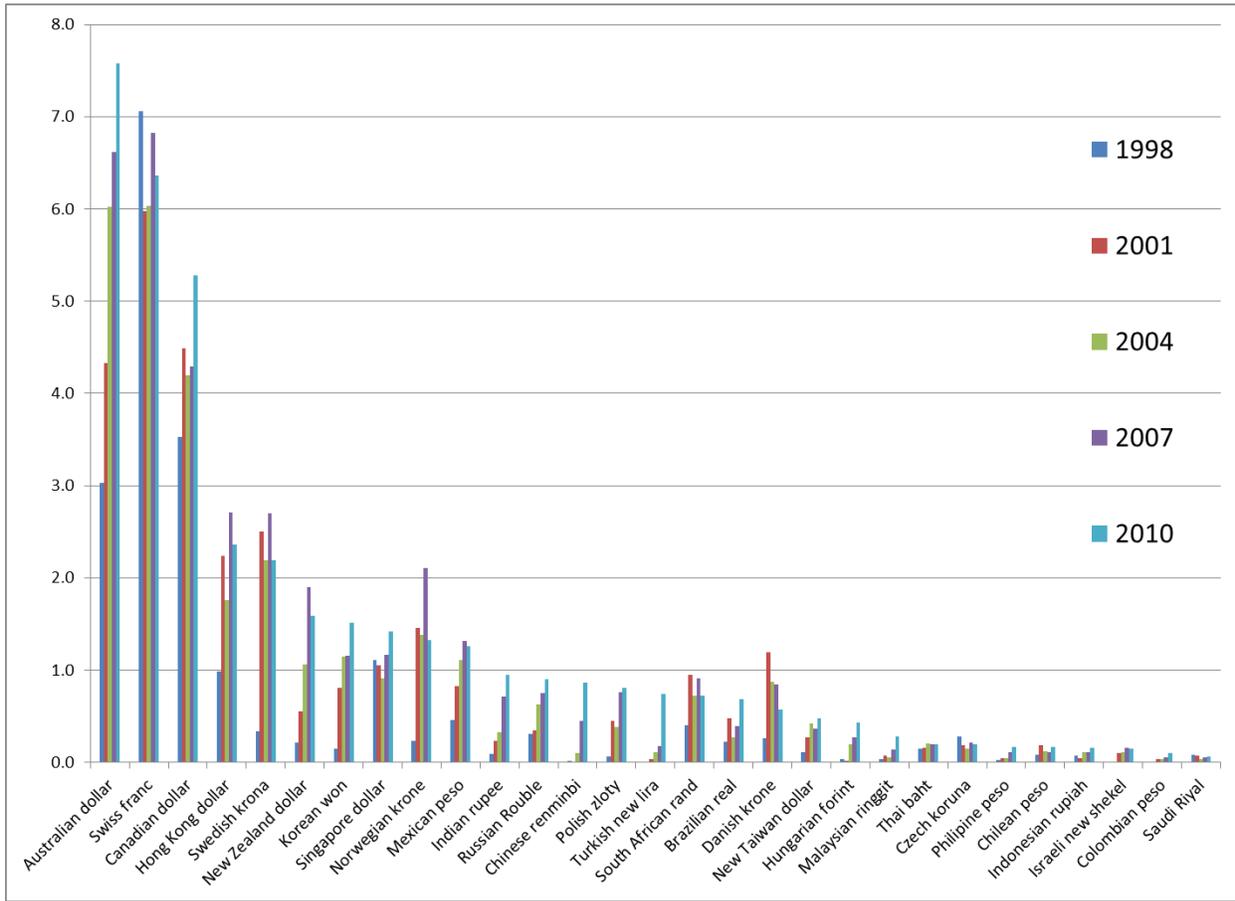
Figure 1: Market Share in currency trading, top four



Source: BIS Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity

Interestingly, there has been somewhat more movement in the shares of the currencies outside of the top 4, although from a low base. Figure 2 plots the market share in foreign exchange trading of all the other currencies covered by the BIS's tri-annual survey. In particular the Australian and Canadian dollars have increased their market shares to join the Swiss Franc in the 5% - 8% range.

Figure 2: Currency composition of currency trading, excluding top four



Source: BIS Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity

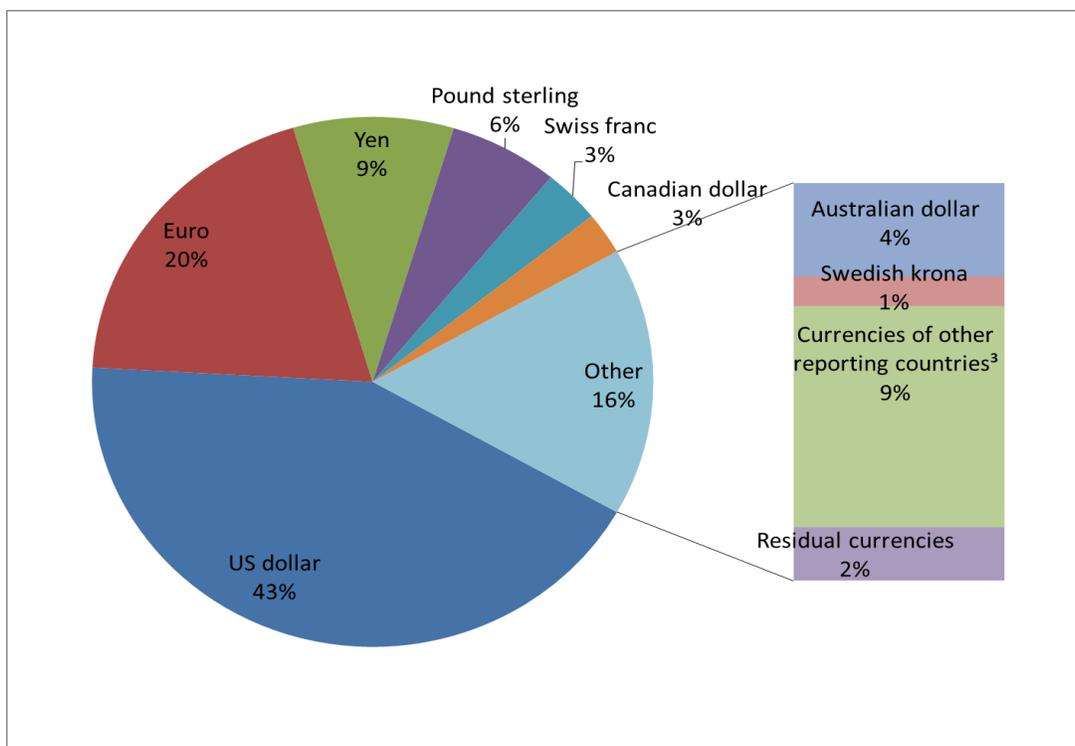
Within Latin America, the focus of this paper, the Mexican peso has almost tripled its market share from 0.5% to 1.3% and the Brazilian Real has more than tripled its share from 0.2% to 0.7%. These are large proportional increases, albeit from a low base.

Considering specific currency pairs, a very significant 28% of the average US\$1.1tr/day of currency trading through April 2010, was accounted for by the US dollar/Euro pair, followed by 14% for US dollar-Yen trades and 9% for US dollar - Pound trading. The largest volume for a currency pair not involving the dollar is a tie between the Euro-Yen and the Euro-Pound, each with a share of just 3% of the total market. The US Dollar-Renminbi and US Dollar-Real market shares are equal at just 1% of the total market. And perhaps most tellingly, the entire market of

residual currency pairs (i.e.: those not specifically identified by the BIS, which includes all trading within EM currency pairs) is just some 2% of the total market⁶.

A similar picture emerges considering derivative trading. For example, Figure 3 illustrates the market share of a set of currencies in global OTC currency derivative trading (swaps, options and forwards) for April 2010. The US dollar had a 43% market share with the Euro capturing some 20% these markets. Other reporting countries, which include the Renminbi and the Brazilian Real but also many other currencies amount to only 9% of the total market and the residual currencies, which include the currencies of smaller Latin American countries held only some 2% of the total global market in these instruments.

Figure 3: The Composition of OTC Currency Derivative Trading



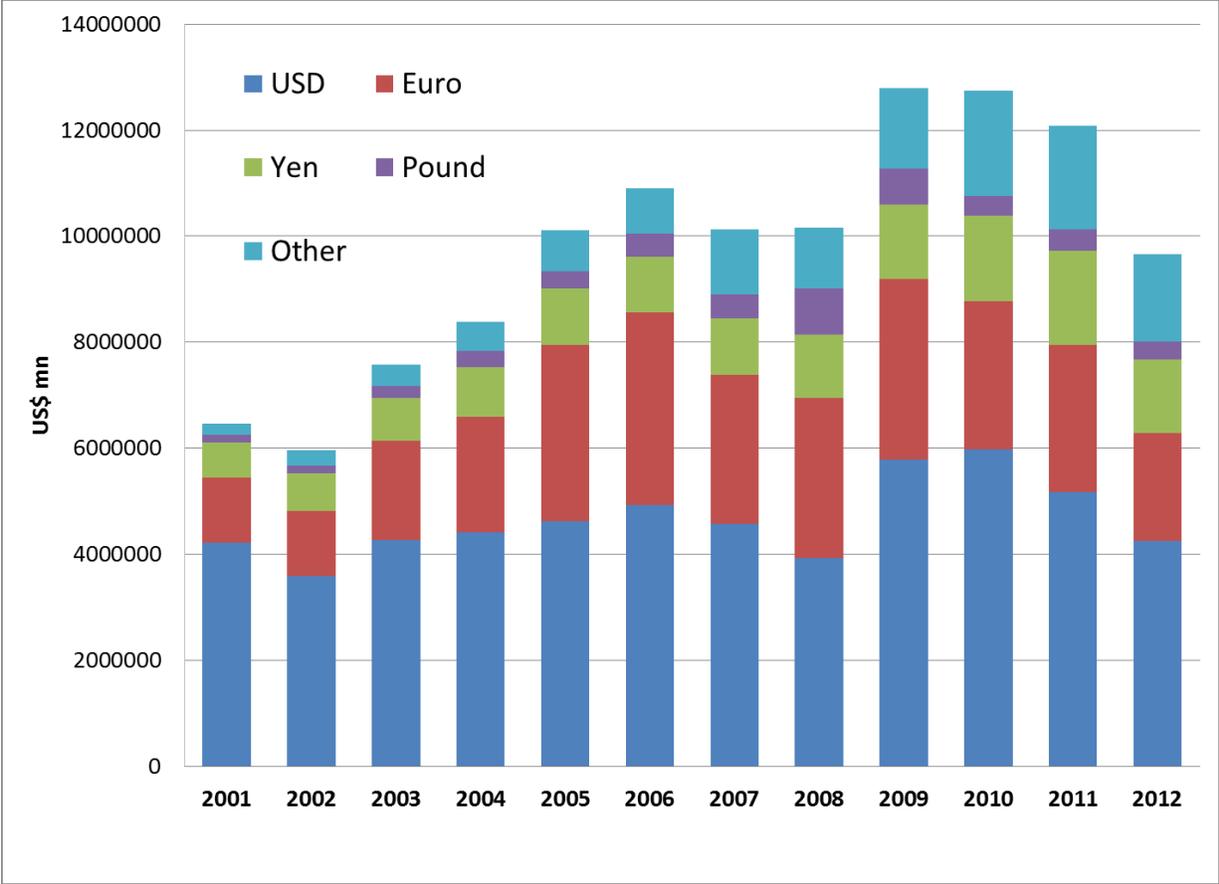
Source: BIS Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity

Turning to bond issuance and using a detailed database of bond issuance across the world, figure 4 plots the currency composition of bond issuance over time. The country and currency coverage of this database is excellent for international issuance but is likely quite patchy in the earlier years of this graph for issues in some jurisdictions and currencies, but by 2006 or so

⁶ Source: BIS triennial survey on currency trading. Note that all residual currency trading against the US Dollar is some 11% of the market (which includes all EM currencies except the Remimbi and the Real) and that all the trading of the Euro against residual currencies (which includes all EM currencies) is some 3% of the total market.

coverage had improved substantially and certainly most major emerging economies appear well-covered since then. The total amount of bonds issued in the world in 2011 was some US\$ 12.1 trillion, including both public and private debt issues⁷. In 2011, about 43% of this issuance was in US dollars, 23% was in Euros, 15% was in Yen, 7% was in Renminbi and 3.5% was in Pounds.

Figure 4: Currency composition of global bond issuance



Source: Dealogic data and author’s calculations

The most popular Latin American currency for debt issuance was the Brazilian Real with about 0.25% of this market followed by the Mexican peso with 0.15% of the market⁸. The Colombian peso had some 0.02% of the market. Focusing further on Latin America, there were some

⁷ The source of this data is Dealogic, the coverage of international security issuance in this database appears very comprehensive but the data appears to miss some issues in local jurisdictions in local currency aimed at local investors.

⁸ This does not include issues in MNV (a Mexican inflation linked index, which accounts for a further US\$2.3bn of issues in 2011).

US\$139bn of bond issuance in 2011 where the “deal nationality” was considered as from Latin America or the Caribbean.

Table 1 gives the currency breakdown of these issues and their “deal nationality”.

Table 1: LAC 2011 Bond Issuance			
Currency	US\$bn	Currency	US\$bn
ARS	436	MXN	16026
Argentina	436	Chile	410
BRL	22606	Mexico	15616
Argentina	255	MXV	2249
Brazil	22173	Mexico	2249
Mexico	178	PEN	356
CHF	741	Chile	13
Brazil	409	Peru	343
Mexico	332	USD	82278
CLF	2737	Argentina	3032
Brazil	47	Brazil	32538
Chile	2690	Chile	5599
CLP	716	Colombia	5330
Chile	716	Costa Rica	250
COP	2808	Dominican Republic	750
Colombia	2724	El Salvador	654
Peru	84	Jamaica	694
EUR	4844	Mexico	17762
Brazil	3455	Panama	545
Mexico	1389	Paraguay	100
GBP	1889	Peru	2055
Brazil	1092	Trinidad and Tobago	175
Mexico	797	Uruguay	200
JPY	156	Venezuela	12594
Mexico	156	UYU	1275
		Uruguay	1275
		Total	139117

As can be seen some US\$82bn (60%) of these issues were in US\$, followed by US\$22bn (16%) in Reales and US\$16bn (11.5%) in Mexican pesos – not including US\$2.2bn Mexican inflation indexed debt (MX). Interestingly the Euro only captured US\$4.8bn (about 3.5%) of LAC “deal nationality” issues.

It is also notable that here are some bond issues within Latin America in other currencies from the region. For example there were US\$255mn of issues in Reals where the deal nationality was Argentine and some US\$ 178mn of Mexican nationality deals in Reals. There were US\$84mn of Peruvian nationality issues in Colombian pesos and US\$13mn of Chilean nationality issues in Peruvian Soles. It should also be noted that there are two currency codes from Chile, CLP and CLF. The only issues in Chilean pesos (CLP) are where the deal nationality is Chilean but interestingly there are Brazilian issues in CLF which is an issue in Chilean pesos but inflation indexed.

Table 2 below gives some statistics on Latin American currency issues outside of the region, and the governing law of those issues. There were only some US\$10bn of issuance in LAC currencies where the governing law was identified in the database as being outside of the region⁹. Of that US\$6.2bn was issued in London (with some US\$5.6bn of that in Reales), and US\$3.5bn in the US.

Table 2: Bond Issuance in 2011 by Currency and by Governing Law of the Issue (Latin American Currencies)

Governing Law of Issue								
Currency	Canada	England	Germany	Japan	Netherlands	Norway	United States	Total
ARS		14						14
BRL	225	5587	77	56		4	430	6379
CLP		153					515	668
COP		9					1075	1084
MXN		337			37		181	555
PEN		72					5	77
UYU							1275	1275
Total	225	6172	77	56	37	4	3481	10052

Hence, while there has then some activity in local currency issuance in international markets, from Latin American and the Caribbean this remains quite limited. According to this database, only some US\$10bn of issuance from Latin America has been registered under the foreign law in local currencies, including London and the US, during 2011, compared to some US\$139bn of total issuance in these currencies. Moreover, bonds in only 7 LAC currencies have been employed in these issues. Some US\$90bn of that US\$139bn were issues in US\$, Euros, Pounds and Yen. LAC still appears to strongly favor these international currencies rather local currencies when issuing abroad. There then appears to be ample room to increase the use of Latin American currencies internationally.

⁹ A large number of issues did not identify governing law, but given the other characteristics of those deals it's likely that these were local jurisdiction issues.

On the Value of Being Able to Issue Internationally in Local Currency

As reviewed in the introduction, the literature on “original sin” has identified several advantages of issuing abroad in one’s own currency rather than in one of the few highly traded international currencies on global markets, and in particular the dollar. Perhaps the main benefit as detailed below is risk sharing.

A country that issues internationally in US dollars runs the risk that US\$ will move in a fashion uncorrelated with movements in domestic prices. Perhaps the most notable example of this was the tremendous appreciation of the US\$, in part fuelled by higher US interest rates that preceded the 1980’s Latin American debt crisis, and that has been heralded as one of the causes of that crisis. Coupled with a collapse in commodity prices, the principle exports of many LAC countries, the debt crisis then plummeted the region into recession and the so-called lost decade.

As noted by Hausmann and Rigobon (2003), it is interesting to note that countries’ real GDP (i.e.: nominal GDP in local currency deflated by a domestic price index – the GDP deflator) is considerably more stable than countries’ GDP as measured in US\$. This comparison is one way to see the potential problem of issuing debt in US\$ rather than in a domestic price index. Table 3 below reproduces this comparison for a number of countries in LAC and the other BRIC’s.

Table 3: Volatility of USD GDP versus Real GDP

	USD GDP Growth	Real Growth
Latin America & The Caribbean	%	%
Bolivia	7.4	1.4
Brazil	17.6	2.2
Chile	11.8	2.4
Colombia	11.8	1.8
Costa Rica	11.8	1.8
Dominican Rep	6.5	2.8
Guatemala	6.2	1.1
Guyana	8.1	3.3
Haiti	16.0	4.8
Honduras	4.5	2.6
Jamaica	6.2	1.8
Mexico	15.3	3.5
Nicaragua	4.2	2.3
Paraguay	14.3	4.4
Peru	9.5	3.6
Suriname	18.3	3.3
Trinidad and Tobago	18.3	3.3
Uruguay	18.9	4.9
Venezuela	17.6	6.5
BRICs		
Russia	22.9	5.3
India	8.7	1.9
China	8.4	1.9
Brazil	17.6	2.2
Average LAC	11.8	3.0
Average BRIC	14.4	2.8

On the basis of this type of analysis and other statistics Hausmann and Rigobon (2003) argue that IDA should lend using a CPI index loan contract and Eichengreen and Hausmann (2000) argue that the IBRD should kick-start a market in CPI indexed debt for emerging economies

more generally¹⁰. However, as discussed above some LAC countries are actually issuing in international markets in nominal currency units (not inflation indexed) which may be even more valuable, as the ability to pay is really associated with nominal local currency values¹¹.

In order to investigate the value of issuing in nominal currency units rather than US\$, we performed a historical simulation exercise. This involved building up a particular debt structure and assuming a particular amortization schedule and roll-over strategy. We assume that debt is on average 5 years maturity, amortizes over the life of the bond with equal annual capital payments and that new debt is issued rolling over all debt that comes due at its nominal amounts. We calibrate the simulations to the average debt levels of each country¹². Further details of the simulation are provided in an appendix to the paper. The results are illustrated in Table 4 below.

¹⁰ While the argument is to create CPI indexed debt, strictly speaking the comparison in Table 3 would motivate the use of GDP deflator indexed debt. Still its likely CPI and the GDP deflator are correlated, although normally the CPI is considered to be weighted more towards non-tradeables.

¹¹ One argument for example is that most taxes are levied on a tax base in nominal currency units.

¹² We plan to carry out some robustness tests to check if the results are invariant to the debt structure adopted.

Table 4: Simulated Benefits of Local Currency Debt

	Local Currency	US Dollars	Volatility LC / US\$
Latin America & The Caribbean	%	%	
Bolivia	2.3	8.1	28.6%
Brazil	3.2	7.1	45.6%
Chile	0.1	0.4	34.6%
Colombia	1.3	5.3	25.1%
Costa Rica	0.9	3.1	27.5%
Dominican Rep	1.3	4.2	29.8%
Guatemala	0.6	1.4	45.1%
Guyana	14.7	17.9	81.8%
Haiti	1.8	6.7	26.6%
Honduras	2.7	4.6	58.4%
Jamaica	6.1	11.7	51.9%
Mexico	0.6	1.4	43.4%
Nicaragua	4.4	5.0	87.8%
Paraguay	1.3	9.5	13.4%
Peru	3.3	3.9	84.9%
Suriname	1.6	2.8	57.3%
Trinidad and Tobago	1.1	1.2	90.4%
Uruguay	9.0	41.2	21.9%
Venezuela	1.7	6.6	25.3%
BRICs			
Russia	4.0	17.7	22.6%
India	0.6	1.8	35.8%
China	0.5	0.7	75.1%
Brazil	3.2	7.1	45.6%
Average LAC	3.0	7.5	46.3%
Average BRIC	2.1	6.8	44.8%

In summary we find that if external debt had been issued all in local currency rather than in US\$, then the volatility of the debt to GDP ratio would have been reduced to less than half for

LAC countries and for the BRIC countries. This represents a very substantial reduction in volatility and hence in risk¹³.

Considering the actual time paths of the simulated debt to GDP ratios, for the case of debt being in US\$ then for several Latin American countries there is a sharp increase in debt in the early years of the 21st Century, 2001/2. The strong dollar at that time coincided with poor economic results in the region. It was when the countries in the region had low growth, and several were in recession, that the dollar appreciated relative to Latin American countries. Hence it is not only that having debt in dollars is risky, in the sense of a more volatile debt to GDP ratio but also that that risk is poorly correlated with growth.

Several important caveats are in order regarding this analysis. Debt management has become much more sophisticated of late in emerging economies and Latin America and the Caribbean is no exception to this trend. As illustrated above, debt-managers issue in several major currencies and not just in dollars, seeking out the best opportunities and given low world interest rates debt maturities have also increased. One caveat is then that the simulations above are somewhat stark in comparing only all local currency vs. all US\$ external debt and with a fixed debt structure that is invariant to developments in global currencies and interest rates. In future work, we plan to investigate further if there is a substantial difference between issuing in US\$ and for example issuing in Euros or Yen. However, as the figures in the previous section illustrate, still the vast majority of external debt of LAC countries is issued in US dollars.

Surveying the global economic situation today there are somewhat similar international circumstances to those in the 1970's. The dollar is rather weak, US interest rates are low and commodity prices are relatively high. While LAC countries have much improved fundamentals, including notably higher reserves backing larger financial systems, high capital inflows and large quantities of debt in US\$ may again be a point of vulnerability. As China slows and rebalances its economy away from investment, commodity prices and particularly metals' prices are likely to fall¹⁴. As the US recovers, at some point US interest rates may rise and there is a very real risk that they will have to overshoot to control inflationary pressures built up during the substantial period of zero rates and quantitative easings. If so the dollar may appreciate and LAC and other parts of the world will again face significant balance sheet effects given the majority of external debt issued in dollars.

¹³ These simulations were also done using Euros instead of dollars and with a portfolio of dollars and euros and the results are roughly the same, namely there is a substantial reduction in risk if external debt were in local currency. We also performed simulations for CPI indexed debt; the results will be incorporated into later versions of the paper.

¹⁴ See IADB (2012) Ch 3, for analysis and discussion of the effect of China's slowdown and rebalancing on commodity prices.

Role of Multilaterals: Promoting Lending in Local Currency

In the above it has been argued that the international monetary system remains heavily focused on the use of the dollar and a select few other international currencies. These currencies dominate spot trading, derivative trading and bond issuance, as well as trade invoicing and reserve assets. It is likely that these roles mutually reinforce each other in particular through the benefits of liquidity and information. As the dollar is so widely used, all know it can be traded in large quantities at low bid-ask spreads, and this adds to its value and hence to its continued use. As the dollar is used so much, spot markets in that currency will reflect a great deal of information and derivative markets will reveal fair estimates of future valuations and risk. As there is then such a tremendous amount of information available, little time or effort has to be spent by any individual actor to investigate about its prospects and potential risks. Hence it is used more, generating yet more interest and information.

These liquidity and information externalities imply that the focus on one or a select few currencies is likely to be economically efficient for the world as a whole. However, that does not mean it is necessarily efficient for each individual actor or country, relative to say a world where many countries' currencies are used. In other words the dollar standard may imply a net benefit for the world but this may represent a net cost for some individuals or countries.

In particular in this paper we have focused on the ability of a country to issue debt in international markets in its own currency may be extremely valuable for that particular country. Currently, only a small number of Latin American and Caribbean countries issue in their own currencies in international markets. Presumably in these cases the additional benefits of issuing in local currencies was considered to outweigh the costs.

As a recent example, in September 2011, Chile reopened a global 2020 issue in pesos and issued in New York some US\$349mn worth of peso bonds at a yield of 4.4%. About one year later, Chile issued US\$750mn 2022 US\$ bond in New York at a 2.379% yield and a 2032 maturity for a yield of 3.714%¹⁵. Abstracting from the different issue dates, this gives a recent pricing point for Chile suggesting a premium of around 2.0% for issuing in pesos rather than in USD. This premium may reflect different components; that the dollar is expected to appreciate against the peso, risk and liquidity.

¹⁵ This was some 55 and 75 basis points over US Treasuries, respectively. See <http://www.latinfinance.com/Article/3108918/Chile-Taps-Tight-Dollar-Funds.html> and <http://en.mercopress.com/2012/10/26/chile-places-1.5bn-dollar-bonds-at-lowest-financing-cost-of-any-emerging-country>

However, the Chilean peso market is surely considerably more liquid than several other currencies of the region. For countries with less liquid currency markets, given the dominance of the US\$, the interest rate premium to issue in local currency rather than in dollars will be much larger. Hence those countries will tend to issue in dollars in external markets rather than in their own currencies. And yet as we have reviewed above this choice may lead to poor risk sharing.

Multilateral development banks tend to be USD based institutions with their accounts reported in that currency. This implies that contracts written in other currencies imply a currency risk that needs to be managed. For example, the standard loan contract of the Inter-American Development Bank (IDB), the single largest lender to LAC, is a Libor based floating rate contract in US dollars. In recent years the IDB has introduced much more flexible arrangements allowing countries to borrow in any currency or index, when there is a swap or other means available for the IDB to hedge the currency risk that that implies to the IDB balance sheet¹⁶. But this implies that the ability of the IDB and other multilaterals to lend in local currency is dependent on the same liquidity parameters that may determine if the country finds it economically beneficial to issue in local currency or not.

There is something of a Catch 22 here¹⁷. Multilaterals are able to lend in local currencies to those emerging economies that already have some degree of liquidity in their local currency markets, such that the multilateral can issue in that same currency or purchase a currency swap to hedge the risk out of that currency and into dollars. The IDB for example, is able to offer loans to Brazil in Reales or to Mexico in pesos as these currency markets are reasonably well developed. But as we have seen Brazil and Mexico can already issue in local currency. Indeed in their local markets these sovereigns are considered AAA credits and so given current policies, while a multilateral may be a lower risk AAA the difference is marginal and so the gain in yield borrowing from a multilateral versus issuing in local currency is minimal. However, for those sovereigns that do not have liquid local currency markets, a multilateral development bank finds it difficult to lend in local currency as it may not be able to issue in that currency or find the relevant swaps to hedge - as the market is not liquid.

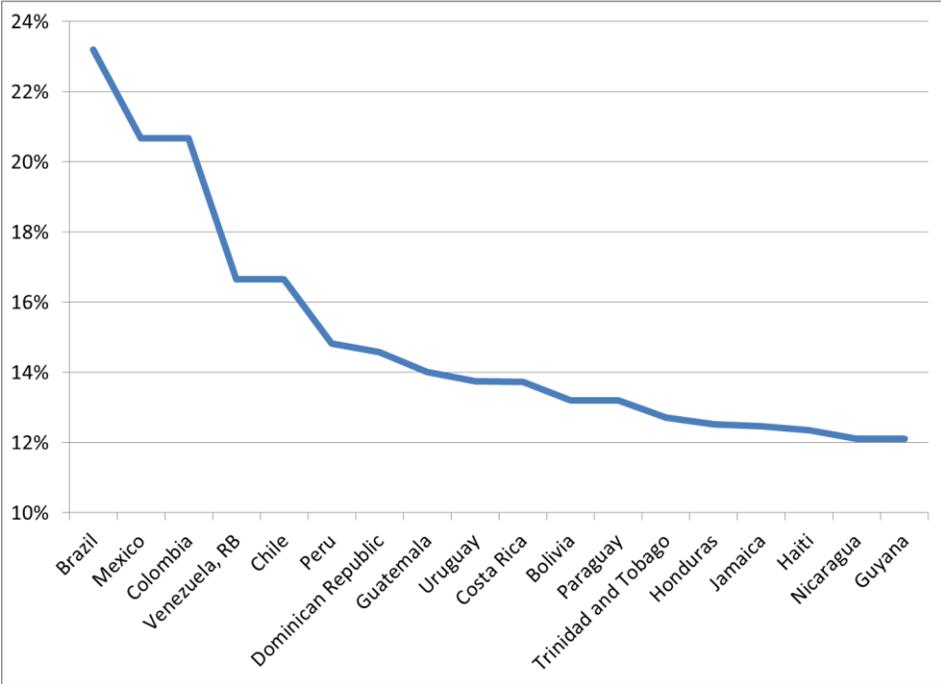
The IDB lends to 26 borrowing countries in LAC. If lending was in local currency to these 26 borrowers there would then be substantial diversification benefits. To see this, consider an equally weighted portfolio of currencies to LAC countries. The Brazilian real had an annualized standard deviation of around 23% over the sample analyzed but if that portfolio had been in

¹⁶ Any residual currency risk remaining on the balance sheet must then be deducted from capital leading to a reduced amount of total potential lending to the region.

¹⁷ Catch 22 is the title of the famous novel by Joseph Heller. The catch was that if a bomber pilot in the second world war could be relieved of his duties if he claimed insanity, but if he claimed insanity that would then be a sure sign that his mind was actually completely intact.

Reales and Mexican pesos the standard deviation would have fallen to 21%, with just 5 countries this would have fallen to around 17%. These diversification benefits are illustrated in Figure 5 below.

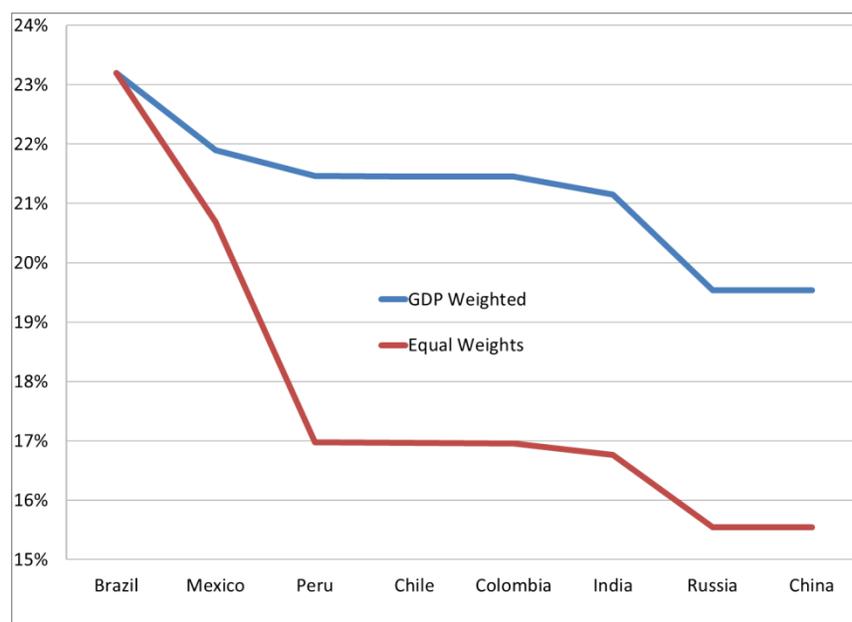
Figure 5: Volatility of Latin American Currency Portfolios



Source: author's calculations

It is interesting to consider whether LAC currencies might be complemented by other emerging country currencies in such a portfolio. In Figure 6, we combine the larger LAC currencies with those of the BRIC's to consider the value of adding further currencies to the portfolio. For an equally weighted portfolio over the period of analysis there are some, albeit rather small gains to the global approach. However, it is perhaps unrealistic to consider an equally weighted portfolio (or restrictive in the sense that this would surely limit lending to the larger economies). If one considered a GDP weighted portfolio then the benefits of diversification across LAC are smaller (as given its size, Brazil dominates) and the benefits of introducing other BRIC's is consequently greater. This suggests cooperation across multilaterals might be valuable to diversify currency risks.

Figure 6: Diversification Benefits Currency Portfolios of Major LAC Economies and BRIC's



Source: authors' calculations

Indeed, this cooperation has already taken place with the creation of an entity known as The Currency Exchange Fund (TCX) given an initiative of the Dutch aid agency¹⁸. TCX is a fund that is set up with its own capital and whose objective is precisely to attempt to solve the Catch 22 referred to above. The idea is that the IDB or other multilaterals might continue to lend in dollars, but the borrower may then apply to TCX for a currency swap. TCX accepts the currency risk onto its books (it tends not to hedge) but benefits from the type of diversification risk illustrated above, as it conducts these types of operations across the globe. However, compared to the large sovereign lending operations, TCX remains relatively small. It focuses on those currencies where multilaterals would find it hard to hedge currency risk anyway, but even so its size makes it appropriate for relatively small private sector operations and not for general sovereign lending.

Still, the TCX example illustrates one way forward to exploit global risk sharing and diversification benefits. A second way forward may be through the use of guarantees. As the capacity to pay debt is related to nominal GDP, debt in nominal local currency units is most correlated with the ability to pay; this is simply another way of stating that debt in local currency implies a less volatile debt to GDP ratio. In turn this implies that a guarantee on such a contract will operate more on the willingness of the borrower to pay than the ability to pay. Given their preferred creditor status, multilaterals have a comparative advantage in

¹⁸ See www.tcxfund.com for further information on TCX. See IDB (2007) for further information and details of IDB support to TCX.

guaranteeing willingness to pay risks, rather than ability to pay type risks that are best diversified through market means. Hence a more efficient use of multilateral development bank capital may be to guarantee contracts that share risks including local currency instruments than say lending in dollars. With judicious pricing this may tip the balance of a sovereign to issue in local currency by reducing the relevant premium versus dollar issuance. However, this proposal requires addressing the currency risk that multilaterals would then need to either maintain on their books or hedge as discussed above and would also require further analysis for example regarding the appropriate pricing of such guarantees.

Conclusions

In this paper it has been argued that the global currency markets remain dominated by the US dollar and a very few other global currencies. Such currencies make up the vast majority of spot trading, derivative trading and bond issuance. It is likely that the massive liquidity advantage and that these currencies maintain is one driver for why emerging economies continue to find it economically efficient to issue external debt in foreign currency rather than in local currency. Emerging economies have been issuing in nominal domestic currencies in foreign jurisdictions. There was at least US\$10bn issued in 7 LAC currencies in 7 non-LAC jurisdictions in 2011 but the premium that was required presumably did not justify reducing the US\$82bn or so of LAC dollar issuance in the same year.

In other words, it appears that the premia that emerging economies must pay to issue external debt in their own currency, in the eyes of domestic policy makers, rarely warrants the benefits. As a recent example, Chile, one of the best emerging credits in the world given recent bond issues in New York in dollars and in pesos, pays roughly a 2% premium for peso issuance, (only marginally less than the actual dollar yield). While it is hard to disentangle this premium into constituent elements, a significant part is surely related to liquidity.

The benefit of domestic currency issuance for emerging economies is largely related to risk sharing. As the capacity to pay debts is related to nominal GDP, issuing in nominal local currency units ensures that debt is most closely correlated with ability to pay and debt to GDP ratios will be more stable.

Multilateral development banks tend to be dollar-based institutions and their standard lending contracts are typically dollar based ones. In recent years, however, they have certainly become much more flexible and most may now lend in domestic currency but must then manage the currency risk that this implies in some fashion, either through hedging or through the use of extra capital. Ironically, multilaterals may be able to lend in local currencies only where those sovereigns can already issue in local currencies as those are the markets where hedging may be feasible.

In order to escape from this Catch-22 some creative thinking is required. One approach is for a third entity to take on the relevant currency risk. Already there have been some initiatives along these lines, and these could potentially be scaled up, to allow local currency lending in greater quantities to sovereigns. Alternatively guarantee instruments might be developed on local currency instruments to tip the balance in favor of local currency issuance by reducing the premium to issue in local currencies versus in US dollars.

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