How Useful Are Clever Solutions?

Why fashionable proposals often don't work, as in the case of a new approach to dollarized debt and "original sin"

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KNOTTY PROBLEMS abound in economics. For example, how can the poor obtain access to credit, or how can international economic policies help to cut short the duration of kleptocratic, despotic regimes? And clever solutions keep bubbling up. Give the poor formal title to their land because that will give them collateral against which to borrow. Declare the debt issued by terrible regimes "odious" and unenforceable so that investors will be unwilling to finance such regimes. The solutions seem ingenious, low-cost responses to the problems. Yet they are rarely implemented.

Often, this is not because there is a conspiracy to ignore the solutions, but because both the underlying causes of the problem and the ramifications of the proposed solution are broader than have been allowed for. Not only is it possible that the clever proposal will not solve the problem, but it may also have the unintended consequence of detracting from the less attractive, painful reform that is ultimately needed to solve it. This is not necessarily to say that one shouldn't propose clever ideas or try to implement them, but one should be aware that to have a high probability of working, solutions have to be robust—that is, allow for the possibility that the underlying problem is not the obvious one. Many clever solutions are not robust. Consider the following example.

Dollarization and original sin

The dollarization of liabilities has become widespread in recent years. More and more countries, banks, and firms in emerging markets issue debt denominated in a foreign currency (typically the dollar), even though they don't have large dollar revenues. When a country's currency depreciates, the resulting currency mismatch between revenues and obligations can have serious consequences—sovereign defaults, banking system meltdowns, and widespread corporate bankruptcy.

Given these risks, why do countries persist in borrowing in foreign currencies? One explanation—referred to as the "original sin" hypothesis—is that not only do countries not have any choice now but also they won't have a choice in the future. For some unspecified reason, perhaps to do with long-forgotten original sins, investors have feared a given country, refusing to accept paper denominated in its currency. In other words, no matter how good the country's fiscal and monetary situation becomes, it has little hope of escaping the rejection, albeit irrational, of the market.

But recent studies show the empirical basis for this argument is shaky. Its logic is also particularly problematic when we see investors returning to lend to Latin American economies that had defaulted on them just a few years before. Such historical experience suggests that investors have short memories for sin; certainly their memories don't extend over centuries or even decades. Nevertheless, the original sin argument is politically attractive because it absolves countries of responsibility for their current condition.

A related but more plausible explanation for the steady increase in dollarized debt is that countries are forced into this position because their monetary policies lack credibility. If a country issued debt in domestic currency, the argument goes, it would have an incentive to inflate its way out of debt. Investors unfairly believe it will succumb to that temptation even though its policies have recently improved. But with dollarized debt, the country wouldn't have this incentive, and so investors would be more willing to lend to it.

What is the clever solution? Some suggest that the World Bank or the IMF issue bonds in the country's domestic currency and then lend the proceeds to the country, with repayment also denominated in the domestic currency. These international financial institutions (IFIs) are presumably more sensible than market investors and aren't fazed by original sin or misleading reputations. They can also guarantee that the country will not inflate its way out of trouble, giving investors reasons to hold domestic currency debt that they have issued (alternatively, the IFIs can issue debt indexed to inflation). Such proposals have been floated in a number of forms, with varying degrees of sophistication and varying objectives. Some of the most reasonable are those of Barry Eichengreen and Ricardo Hausman ("How to eliminate original financial sin," *Financial Times*, November 22, 2002) and of Eduardo Levy-Yeyati ("Financial Dedollarization and the Role of IFIs: Dedollarizing Multilateral Credit" (unpublished; Buenos Aires, Argentina: Universidad Torcuato di Tella)).

Would the clever solution work? The key question is what really drives debt dollarization? History suggests that countries have graduated from issuing foreign currency debt to issuing debt denominated in domestic currency, typically by fixing fundamental problems like excessive deficits or a tendency to inflate, rather than by obtaining absolution for sins from a higher power.

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Dollarization and fear premiums

To see whether this solution is robust, consider another explanation for dollarization of liabilities. Typically, a country's debt isn't sold only to foreigners but also to locals. This is natural since locals are more likely than foreigners to believe they can enforce repayment. The marginal domestic investor will care about the pattern of returns the debt offers. Finance theory indicates that he or she will be prepared to pay more for (accept lower returns from) a security that is expected to retain its value or go up in bad economic times relative to a security that is expected to plummet in value. The former security provides more insurance.

What do citizens in these investing countries want insurance against? One major problem in an emerging market economy is that it's prone to adverse shocks that cause foreign lenders to stop lending, forcing a real currency depreciation as well as high inflation in the country. Economic activity tends to collapse, causing immense hardship for the people. Consider what happens to the securities at this time. As long as the country doesn't default, dollar-denominated debt goes up in value because of the real depreciation, while debt denominated in local currency falls because of inflation and depreciation. Domestic investors who want protection against crises caused by "sudden stops" would prefer dollar-denominated debt because it provides valuable insurance, and they would thus be willing to accept a lower rate of interest on it. (Of course, such debt is valuable only under the reasonable belief that the government won't default on its debt or that, even if it defaulted, it would repay in proportion to its outstanding obligations.)

This doesn't immediately imply that domestic issuers would rush to issue such debt, for they would have to pay more in bad times. But even though, in a perfect world, issuers would be indifferent between dollar and domestic currency debt, in the real world, ministers, bankers, and industrial managers might not be. Given an expected revenue stream with which to repay, a minister would be able to borrow more upfront with lower-interest dollar debt. If the country finds itself greatly constrained in its borrowing, dollar debt might be attractive even if a minister isn't myopic. If one adds the very real possibility that he doesn't look beyond his short term of office, a minister might be extra willing to accept the uncertain, longer-run risk for the certain, short-run budgetary flexibility. Bankers and chief executive officers of industrial firms might feel similarly.

In these circumstances, will the clever solution work? Absolutely not. The IFIs would have to pay the same risk premium when they issue domestic currency-denominated debt as does the country. If the country borrowed in local currency through these institutions, it would simply add a costly layer of intermediation to its borrowing costs. That said, if the IFIs were willing to step in to such an extent that the country didn't need to borrow from its own citizens—an extremely unlikely scenario—then the holders of the country's debt would all be foreigners and the country wouldn't need to pay a premium.

One should also be careful about condemning dollarization out of hand: banning it might seem another clever solution. Although a currency mismatch is a problem in the midst of a crisis, one cannot judge the merit of the actions that led to it simply by looking at outcomes. There are costs of banning dollarization—such as a country or a firm being less able to borrow or having lower hedging possibilities. These have to be traded off against the potentially distorted incentives for issuers to raise excessive amounts of dollar debt.

Without a clear sense of the costs and benefits of banning dollarization, a robust policy might be to work on fixing the deep underlying causes while taking measures to limit the obvious risks. The big fixes would include boosting the private saving rate, strengthening revenue collection, cutting expenditures so a country accumulates spare capacity for bad times, and increasing a country's ability to export its way out of sudden capital inflow stoppages. Such a policy of "living with dollarization" may be neither clever nor quick, but, in the long run, it is more likely to work. Of course, such a policy is not robust if "original sin" is the true problem. Fortunately, history suggests this policy works. ■