

## Original Sin & Financial Crises

As mentioned in class, the financial crisis in Thailand can be explained through the original sin situation. The concept is derived from the Christian doctrine, specifically the origins of humanity's sins that arose from the Garden of Eden when Adam and Eve consumed the fruits from the forbidden tree of knowledge. This concept was then redefined by economic scholars Barry Eichengreen, Ricardo Hausmann, and Ugo Panizza to refer to the "inability of a country to borrow from abroad in its own currency" (Eichengreen, B., Hausmann, R., and Panizza, U., 2007).<sup>1</sup> According to Eichengreen, Hausmann, and Panizza, most countries, except for the countries holding the 5 strongest currencies (the US dollar, the yen, the pound sterling, the Swiss franc, and the euro) are prone to or have been affected by the original sin situation causing financial instability and changes in macroeconomic policies.<sup>2</sup> The definition of original sins has evolved over time and as such, these same scholars have included definitions for domestic and international original sins. According to an unpublished paper by the aforementioned scholars, the most recent definition of original sins refers to as "the inability to borrow domestically long-term at fixed rates in local currency."<sup>3</sup>

Eichengreen et al created a measure range for the original sin, which is between 0 and 1, so countries that have a high levels of original sin are near or at 1 and consequently suffer more. Asia Pacific has an original sin of 1.00 between 1993-1998, but dropped to 0.94 between 1999-2001. Among the financial centres of the world, the measure of original sins are 0.58 between 1993-1998, to 0.08 between 1999-2001.

In 2003, Eichengreen et al proposed a 4-step solution to the original sin situation which goes as follows:

"Step 1 is the development of an inflation-indexed basket of currencies of emerging and developing countries, 'the EM index.' Step 2 is for multilateral institutions such as the World Bank to issue debt denominated in this index and possibly also to convert a portion of their existing loans into claims denominated in it. Step 3 is to deepen and broaden the EM market by having G-10 sovereigns issue a portion of their debt in this instrument and swap their currency exposure with the countries in the EM index. And step 4 is to then encourage institutional investors and mutual funds to create products that add credit risk to the index and as a way of further encouraging the development of the market."<sup>4</sup>

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<sup>1</sup> Eichengreen, B., Hausmann, R., and Panizza, U., (2007). "Capital Controls and Capital Flows in Emerging Economies: Policies, Practices and Consequences." Edited by Sebastian Edwards. Conference held December 16-18, 2004. University of Chicago Press, 2007.

<sup>2</sup> Eichengreen, B., Hausmann, R., and Panizza, U., (2002). "Original Sin: The Pain, the Mystery and the Road to Redemption", paper presented at a conference on Currency and Maturity Matchmaking: Redeeming Debt from Original Sin, Inter-American Development Bank.

<sup>3</sup> Eichengreen, B., and Hausmann, R., (2003). "Original Sin: The Road to Redemption."

<sup>4</sup> Eichengreen, et al, (2003)

Arnaud Mehl and Julien Reynaud (2005) focused on domestic debt composition as it is “instrumental in assessing the financial vulnerability of emerging economies owing to its sheer size and swift growth.”<sup>5</sup> Mehl and Reynaud concluded six theoretical determinants of original sin in, *The Determinants of “Domestic” Original Sin in Emerging Market Economies*: (1) Level of the debt burden, (2) Monetary credibility, (3) Slope of the yield curve, (4) Size of the investor base, (5) Political economy considerations, (6) the exchange rate regime.<sup>67</sup>

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<sup>5</sup> Mehl, A.; Reynaud, J. (2005). "The Determinants of Domestic Original Sin in Emerging Market Economies". European Central Bank Working Paper.

<sup>6</sup> Mehl, A.; Reynaud, J. (2005)

<sup>7</sup> Eichengreen, et al, (2003)