Original Sin and Monetary Policy

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Abstract

This paper verifies impacts of the liability mismatch in currency, called "original sin", on the monetary policy. The original sin problem causes macroeconomic instability through balance sheet effects. In emerging economies, the problem is a serious and salient fact. To analyze the problem, we apply a small open economy DSGE model with international credit-market imperfections, in which we focus on the terms of trade as the cause of balance sheet effect. In this model, we show that the balance sheet effect plays an important role for investment and then the capital accumulation and amplifies macroeconomic fluctuation. The change of the terms of trade fluctuates total debts and the net worth, it leads to the risk premium change. Eventually, these changes impact on inflation and output through fluctuations of the capital accumulation and marginal costs. As a result, we indicate that the original sin affects the choice of monetary policy rules.

keywords : Small open economy, Original sin, Financial accelerator

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