In the past two decades, the share of external sovereign debt in emerging economies denominated in foreign currency (FC) has fallen. I document that in Brazil, Colombia, Mexico and Peru, FC debt was mainly substituted by debt denominated in local currency (LC), while inflation-indexed (indexed) debt represented a small proportion. In Uruguay, on the contrary, FC debt was largely substituted by indexed debt. To study the evolution over time and across countries of the currency denomination of sovereign debt, I use an infinite horizon small open economy model in which inflation is costly. Each period, a government that cannot default and lacks commitment regarding its monetary policy, optimally chooses inflation and the issuance of LC, FC and indexed debt. The government chooses debt currency denomination by balancing hedging and incentives properties. On one hand, the exchange rate features a negative correlation with income, making LC and indexed debt useful securities in terms of hedging. On the other hand, the government is tempted to use inflation surprises, in the case of LC debt, and real exchange rate depreciation surprises, in both cases, to dilute the value of its debt. FC debt acts as a commitment device, because its value cannot be diluted. I derive analytical expressions to gain insight into the nature of these trade-offs and solve the model numerically to show the effects of economic evolution and institutional changes in monetary regimes on the currency composition of these Latin American countries. A prolonged period of expansion, a low inflation target and a high cost of deviating from it, can explain the increase in the share of LC debt and the small share of indexed debt.

JEL classification: E52, F34, H63

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