

RESEARCH BRIEF

International Currencies and Capital Allocation

Based on BFI Working Paper No. 2018-15, “International Currencies and Capital Allocation,” by Matteo Maggiori of Harvard; Brent Neiman, Professor of Economics at Booth School of Business and Director of [BFI’s International Economics Initiative](#); and Jesse Schreger of Columbia University

KEY TAKEAWAYS

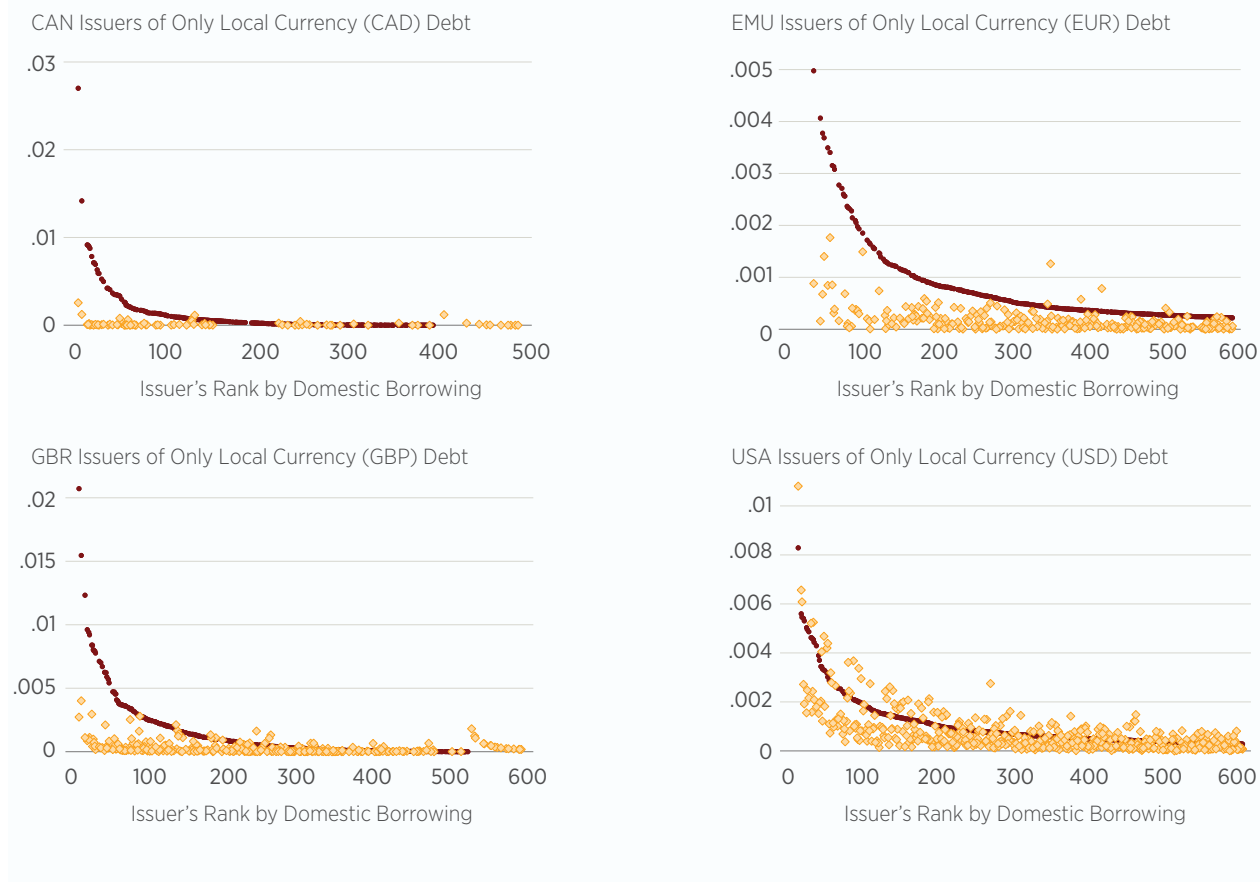
- ✓ Most small firms that issue only local currency bonds do not borrow from international investors
- ✓ The exception is the US, as foreign investors hold more dollar-denominated debt
- ✓ The currency of a bond is a better predictor of which country holds it than the nationality of the firm that issues it
- ✓ Since the financial crisis, the US dollar has become significantly more important, and the euro has become less important, as an international currency

If you are a small or mid-sized business in Canada and want to borrow from investors in Germany, it might be difficult to do so with bonds denominated in Canadian dollars, your home currency. It’d be a lot easier if you had a pretty sophisticated corporate treasurer’s office and paid various banking fees to hedge currency exposures. You could then issue your bonds to the German investors in euro-denominated debt.

The same holds for, say, Australian firms that want to access Canadian investors, for German firms looking to borrow from British investors, and for many other small or mid-sized firms hoping to take advantage of foreign investment. There is only one country for whom these cost barriers do not exist—the United States. US firms that issue only US dollar bonds are uniquely able to borrow from abroad. This phenomenon, and the facts and implications surrounding it, are explored in “International Currencies and Capital Allocation,” by Matteo Maggiori of Harvard; Brent Neiman, professor of Economics at Booth School of Business and Director of BFI’s International Finance, Macro and Trade Initiative; and Jesse Schreger of Columbia University.

Figure 1 • Corporate Debt from LC-only Issuers in Domestic and Foreign Portfolios, 2015

● Domestic ● Foreign



The agglomeration of yellow diamonds in the US chart on and above the line formed by the red dots, indicates the relative ease of US businesses to borrow internationally; other countries are more dependent on domestic sources of financing.

Neiman and his colleagues use a novel security-level data set with \$27 trillion in global investment positions to demonstrate that portfolios at both the macro and micro levels are driven by an often-neglected aspect: the currency of denomination. The authors' research uncovers three findings that provide insight into this phenomenon. In doing so, their work suggests the importance of maintaining a currency's value in bad times and cautions against policies that could negatively impact the global use of that currency in financial contracts.

Three findings...

Finding 1: Investors' bond portfolios exhibit strong home-currency bias.

Economists have long held that the nationality of a bond's issuer is key for determining who holds the bond (the authors' focus is on corporate bonds). For example, if a bond were issued by a Canadian firm, you can assume that the holder of that bond was Canadian.

This phenomenon, referred to as "home-country bias," is the subject of a voluminous academic literature and is embedded into standard models of the international macroeconomy, the kind that would be found, say, at central banks or the International Monetary Fund (IMF).

This new research shows, however, that currency is an even better predictor of who are the bondholders. If bonds are denominated in Canadian dollars, even if the bonds are issued by a German or Japanese firm, it is likely that Canadian investors hold that debt. Once one knows the currency of a bond, additional information on the nationality of the issuer explains very little about who the investor is.

The authors refer to this as "home-currency bias," and taking it into account may be important as analysts, governments, and central banks consider the international wealth transfers that accompany exchange rate shocks as well as the implications of policies that open countries up to foreign borrowing.

Finding 2: Large firms often issue bonds in foreign currencies and borrow from foreign investors. Small and medium sized firms that borrow only in their own currency borrow only from domestic investors.

Let's turn our attention from investors to firms and imagine a German company that wants to borrow from Canadian investors. However, Canadians typically buy Canadian dollar-denominated debt. Only those German firms that invest time and money into developing a rather sophisticated corporate treasurer's office or pay large financial advisory fees issue debt in Canadian dollars.

For large firms, these additional costs are feasible, but for small and mid-sized companies, who make up the majority of businesses in most countries, that is rarely the case. A key insight here is that when countries liberalize rules and encourage foreign borrowing and lending, the large firms disproportionately benefit.

Finding 3: The global willingness to hold the US dollar renders the United States the unique exception to the above patterns.

Conventional wisdom says that the US dollar is a global currency and holds a special place in the international financial system that, perhaps, may allow the US government to borrow more cheaply than it otherwise could, a phenomenon often referred to as the "Exorbitant Privilege."

Economists have long held that the nationality of a bond's issuer is the best guide for who holds the bond. However, this new research shows that the bond's currency does an even better job of describing which investors include it in their portfolios.

Figure 2 - Dollar and Euro Shares of Cross-Border Corporate Bond Positions

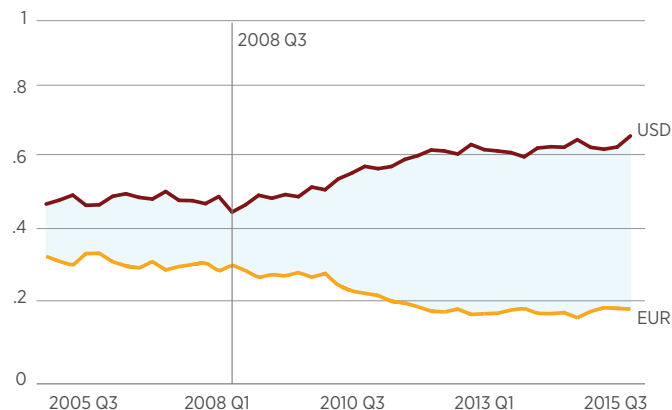


Figure plots the share of dollar and euro denominated corporate bonds in total cross-border holdings (i.e. $i \neq j$).

The authors reveal a novel benefit of this special status of the US dollar – the US is the one country in the world where even firms that only issue bonds in the local currency are able to attract a lot of foreign financing. Small and mid-sized businesses in the US borrow in dollars and are able to easily access foreign investors. But the equivalent small and mid-sized Canadian firms that issue only in Canadian dollars have a very hard time raising money from abroad. (For an illustration of this phenomenon, see Figure 1.)

... and a revelation

The authors started with recent data which paints the US dollar as the only global currency. But as they extended their analysis back in time they uncovered a striking shift in the time-series of global portfolios: this role of the dollar has increased, and that of the euro has decreased, even during the past ten years.

The dollar was the currency of denomination for roughly half of global cross-border holdings of corporate debt in the authors' data in 2004 and the euro also accounted for a substantial amount, about 35 percent. (See Figure 2.) However, following the global Financial Crisis of 2008, the euro's share rapidly declined to below 20 percent, while the dollar's share rose to nearly 70 percent (whether the crisis in the US, Europe, or some combination thereof was the cause of this shift, the authors cannot say with confidence).

This massive international portfolio reallocation is important in its own right, but also suggests further research to determine how the three facts described above changed in response to variation in the international status of the dollar and the euro. Finally, while the data represented in Figure 2 are for corporate bonds, a similar divergence holds for government bonds as well as those issued by financial and by nonfinancial companies.

CLOSING TAKEAWAY

This paper's findings highlight the value to the United States of issuing the dollar, currently the world's only international currency. It brings a benefit to small to mid-sized firms in the US that can more easily borrow from abroad.

Conclusion

This research demonstrates that currency really matters for understanding global capital allocation. The authors show that with the exception of the US dollar, investors take on much less currency risk than previously thought when buying the debt of foreign companies, even when those companies are located in developed countries like Canada, the European Monetary Union, or Great Britain. Firms can borrow from abroad by issuing in foreign currency, but this is costly, and means that many firms are, in effect, shut out of international bond markets.

These findings highlight the value to the US of issuing the dollar, currently the world's only international currency. Doing so delivers a benefit to small to mid-sized firms in the US, which can borrow from abroad without having to deal with foreign currency issuance. These findings should give policymakers pause before pursuing any policies that might damage the special role that the dollar plays for US businesses. It also makes clear why foreign policymakers surely aim to elevate the international status of their own currencies.

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