International Currencies and Capital Allocation

Overview

Global capital flows across international borders much more today than in decades past. In the U.S., for instance, foreigners today hold nearly 25 percent of U.S. corporate debt, up from near zero in the late 1970s. Understanding the drivers behind international capital flows is important to macro models that link net foreign asset dynamics to the composition of firm assets and liabilities. The authors introduce a new dataset with global investment positions totaling $27 trillion, and show that investors have a strong home currency bias. In fact, the vast majority of firms issue only in local currency and don't even bother to access foreign capital leaving the bulk of all securities denominated in their own currency. The one exception is the willingness to hold the U.S. dollar. So, even small U.S. companies borrowing exclusively in dollars are quite easily able to borrow from abroad. The trend towards the rising role of the U.S. dollar in international finance accelerated with the 2008 global financial crisis.

Investigation

Investor currency preferences are an important part of understanding the dynamics of global capital allocation. However, there is little research on the determinants of cross border investment. The authors introduce a novel security-level dataset with $27 trillion in global investment positions collected between 2003 and 2016 from open-end mutual funds domiciled in over 25 countries. Research into this data set reveals several important findings.

- Investors disproportionately hold bonds denominated in their own country's currency giving rise to a strong home-currency bias. The data show that investors, when choosing among bonds issued in different currencies by the same firm, disproportionally hold bonds denominated in their own currency. The result is that each country owns the vast majority of securities issued in its own currency, even when the issuer is foreign and resides in a developed country.

- This home-currency bias leads to a markedly different allocation of capital across firms. Globally, most firms of all sizes issue only in the local currency and borrow very little from foreigners. Only a small number of large firms issue debt denominated in foreign currency. This means that the vast majority of issuers, even in highly developed countries, receive little bond financing from foreign investors. For those firms that do issue in multiple currencies, there is a positive relationship between the foreigners' holdings of equity and bonds. So, if foreigners are overweight the equity of one of these firms relative to domestic investors, then they are typically also overweight the bonds of that firm. However, for firms issuing in only local currency, foreigners might hold more or less of the equity of these firms, but they are always markedly underweight the bonds.

- The U.S. is the unique exception to these patterns — foreigners are biased towards their own currencies and dollar-denominated securities. Thus, when foreigners buy securities in the U.S., they strongly prefer dollar denominated assets, and U.S. firms find it relatively easy to place their bonds in both U.S. and foreign portfolios.

- Since the 2008 global financial crisis there has been increased allocation of portfolios towards the U.S. dollar. In 2016, the U.S. dollar represented about 70 percent of global cross-border holdings of corporate debt, up from 50 percent in 2004, with the euro falling to 20 percent, from 35 percent in 2004.

Conclusion

The authors introduce a new dataset representing global investment for 25 countries, and from this produce new findings about investor preferences regarding the currency in which the assets are denominated. Specifically, investors have a strong home currency bias, with the bulk of all securities held denominated in their own currency, even those issued by foreign borrowers in developed countries. Firms, especially large ones, can issue in foreign currency and borrow from foreigners if they choose, but it is costly to do so. The vast majority of firms therefore issue only in local currency and do not access foreign capital investments. The exception is U.S. issuers, which have little difficulty borrowing exclusively in U.S. dollars from abroad. This phenomenon leads to an international preference for the U.S. dollar, which has further strengthened since the 2008 global financial crisis, while the role of the euro has weakened. This highlights the rising role of the U.S. dollar in international finance and increased benefits to U.S. firms.