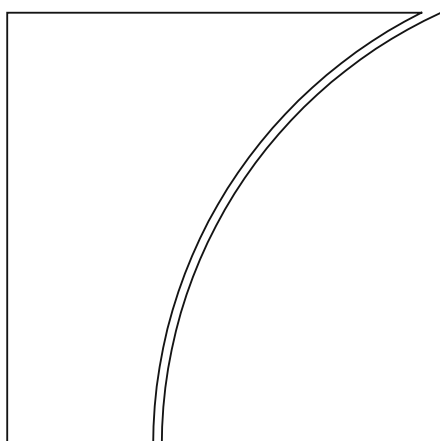




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by Egemen Eren and Semyon Malamud

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Dominant Currency Debt *

Egemen Eren[†] and Semyon Malamud[‡]

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Abstract

We propose a “debt view” to explain the dominant international role of the dollar. Within a simple capital-structure model with debt-currency choice, we show that the “dominant currency” is the one that (1) depreciates in global downturns over horizons of typical debt maturity and (2) has the steepest nominal yield curve. Empirically, we show the dollar fits this description better than other major currencies. The debt view can explain dollar-debt-issuance patterns over the past two decades. It also offers insights into the future of the dominance of the dollar in the aftermath of the COVID-19 crisis.

Keywords: Dollar debt, dominant currency, exchange rates, inflation, monetary policy

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[†]Bank for International Settlements (BIS), Centralbahnplatz 2, CH-4002 Basel, Switzerland. Tel.: + 41 61 280 8408; Email: egemen.eren@bis.org

[‡]*Corresponding author.* Swiss Finance Institute EPFL, Extranef 213, UNIL Dorigny, 1015 Lausanne, Switzerland. Tel.: +41 21 693 2466. E-mail: semyon.malamud@epfl.ch

1. Introduction

The dollar is the most common currency of choice for debt contracts worldwide. According to the Bank for International Settlements, the dollar-denominated credit to non-banks outside the US amounts to around \$12 trillion. Whereas the dominance of the dollar had declined before 2008, the dollar has strengthened its international role since the Global Financial Crisis [Fig. 1, [ECB \(2017\)](#), and [Maggiore, Neiman, and Schreger \(2019\)](#)].

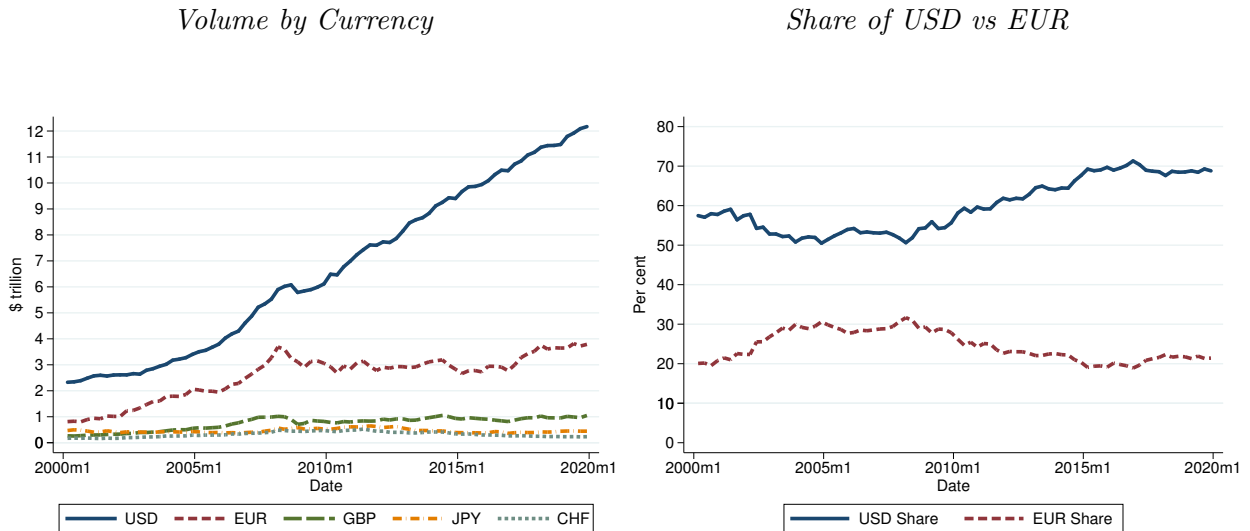


Fig. 1. Currency denomination of international debt and cross-border borrowing of non-banks (amounts outstanding). Source: Bank for International Settlements

In this paper, we study how a single currency can become the most common currency of choice for denominating debt contracts, that is *the dominant currency*, why that choice is the dollar, and why the dominance of the dollar may have declined and recovered in the last two decades. To fix ideas, in this paper, our focus is not on answering why emerging-market firms issue debt in dollars as opposed to local currency. Instead, our primary focus is on why large, global firms issue debt in dollars as opposed to other major safe-haven currencies, such as the euro or the yen.

According to the conventional view, debt issuance in dollars is investor-driven. Investors prefer holding safe assets that tend to appreciate in bad times. Therefore, firms choose the currency

denomination of their debt to cater to investors’ demand. This view faces three potential challenges. First, we show empirically that the dollar is not the “safest” among the major currencies, such as the euro, the Japanese yen, or the Swiss franc, especially over longer horizons. Second, nominal interest rates in dollars are higher than those in these other major currencies. Third, the dollar increased its international role after the Bretton Woods, even as it depreciated considerably against other major currencies in the 1970s (Gourinchas, 2019).

We propose the debt view, in which debt issuance in dollars is borrower-driven. In the baseline version of our model, firms finance themselves by issuing equity and nominal, defaultable debt to optimize the trade-off between tax benefits of debt and the risk of default.¹ Debt can potentially be issued in any currency. Firms issue in dollars if dollar debt maximizes this trade-off. Our first theoretical result is that, independent of the investors’ preferences, firms always issue debt in the most “CAPM-risky” currency. It is the currency that, controlling for issuance costs, has the highest covariance with the stock market *over the horizons of debt maturity*. We call it the “dominant” currency. If investors’ marginal utility co-moves negatively with the stock market, such debt is unattractive for debt-holders, and yet firms still prefer issuing in this currency.

These features of the debt view have two implications and can explain the challenges to the conventional view outlined above. First, while the dollar does tend to appreciate in economic downturns in the short run,² dollar debt represents a better hedge for firms against long-term economic downturns than other major currencies, such as the euro, the yen, or the Swiss franc, making repayment easier in times of distress (in expectation, over the long run). Second, the currency in which firms prefer to issue debt should have a higher risk premium over the long run. As a result, the dollar is the dominant currency for denominating debt, not despite being the riskiest of the major currencies (over the horizon of typical debt maturity), but precisely because of it. A higher associated risk premium leads to higher nominal dollar interest rates. Finally, we show that since the end of Bretton Woods, stock market declines tended to be followed by the depreciation

¹We think of our model as being best applicable to large international firms deciding whether to issue debt in one of the major international currencies with comparable market liquidity and issuance costs. Nikolov, Schmid, and Steri (2018) show that the trade-off theory efficiently explains capital structure dynamics for large firms. By contrast, other theories need to be developed for smaller firms facing a high degree of informational asymmetry.

²In particular, over horizons below one year, the dollar is less risky than many other major currencies.

of the dollar at horizons beyond one year, incentivizing firms to borrow in dollars, thus cementing its dominant international role.

Empirically, we test our prediction that the dollar is the “CAPM riskiest” among the major international currencies. The first prediction of our model is that the dominant role of the dollar in international debt markets might be attributed to market participants’ expectations of a positive co-movement of the dollar with the stock market *over the horizons of debt maturity of firms*, which is typically around five years (see Section 5). We show this empirically in two ways. First, we use asset-price-implied forward-looking expectations of market participants regarding the covariance of the EUR/USD exchange rate and the S&P 500, directly computed from so-called quanto contracts. Second, we compute the historical covariances between the dollar and global stock markets.

A direct way to compute the forward-looking covariance between the stock market and exchange rates is to use so-called quanto forward contracts (Kremens and Martin, 2019). A euro-quanto forward contract for S&P 500, for example, pays off the level of the S&P 500 index *in euros* when the contract matures. As opposed to a contract that pays off the S&P 500 in dollars, the value of this contract depends on the anticipated covariance between the index and the EUR/USD exchange rate. Hence, the price of this contract reflects the expectations of investors about currency returns and currency risk premia. Kremens and Martin (2019) compute the quanto-implied covariance for contracts with a two-year maturity and find the quanto-implied covariance of the EUR/USD exchange rate with S&P500 exhibited a robust downward trend in the post-crisis period and has become negative in the recent years. A negative quanto-implied risk premium (QRP) means market participants believe the euro will *appreciate* against the dollar when the S&P 500 falls, in line with our theory for why firms would issue debt in dollars.

Our theoretical characterization of the dominant currency also has direct implications for the time-series dynamics of the shares of the dollar- and euro-denominated debt. Namely, keeping the distribution of issuance costs constant across firms, our model predicts the share of dollar-denominated debt relative to that of euro-denominated debt is negatively related to the QRP. Consistent with the predictions of our model, we find a strong negative relationship between quanto-implied covariances and the share of dollar debt, suggesting forward-looking expectations of

currency returns are an important driver of firms' debt-currency-denomination choice. Moreover, we interpret this fact as strong evidence of a distinctive prediction of our theory; that is, changes to the currency composition of debt can occur at high frequency and are related to forward-looking expectations because our regressions are at a quarterly frequency.

The debt view also assigns an important role for monetary policy if relative inflation between two countries is an important driver of exchange rates.³ Similar to the predictions regarding the QRP, our model implies the share of dollar-denominated debt relative to euro-denominated debt is positively related to the inflation risk premium of the dollar and negatively related to that of the euro. Therefore, according to our model, central bank inflation-stabilization policies in global downturns and firms' debt-currency choice are closely linked. Strikingly, we find debt-currency shares move more tightly with the expectations about inflation risk premia, especially in the eurozone, which explains debt-issuance patterns over the last two decades, suggesting deflation risk in the eurozone after the crisis is a possible reason why the euro lost its momentum.⁴

Computing covariances from historical data, we find the dollar co-moves positively with the stock market at horizons that typically accord with the debt maturity of firms. This pattern does not contradict the well-documented tendency of the dollar to appreciate in bad times over shorter horizons ([Gourinchas, Govillot, and Rey, 2017](#)). Indeed, we find the dollar co-moves negatively with the stock market for horizons up to a year, making it less risky over the short-run than other major currencies. However, the sign of the covariance switches for longer horizons corresponding to typical maturities of debt that firms issue.

To gain a deeper understanding of the term structure of dollar-stock market co-movement, we further decompose the long-horizon covariances into shorter-term contemporaneous and lead-lag relationships between the dollar and the stock market, proxied by S&P 500 or the MSCI World Index. Whereas the contemporaneous covariance is negative, we find the stock market positively predicts the dollar, and the strength of this effect is sufficient to produce a sign change at longer

³See, for example, [Imbs et al. \(2005\)](#) and [Chowdhry, Roll, and Xia \(2005\)](#) for evidence supporting the relative PPP, as well as [Chernov and Creal \(2021\)](#), who argue PPP is an important driver of long-horizon currency risk premia.

⁴The importance of accommodative monetary policy in helping reduce real debt burdens of firms and the differences across central banks in accomplishing this goal is also acknowledged by the European Central Bank (ECB). See, for example, [Praet \(2016\)](#) and [Cœuré \(2019\)](#).

horizons. To formally estimate the lead-lag relationships between the dollar and the stock market, we estimate a VAR for their joint-return process and study the impulse response for their joint dynamics after a stock-market-depreciation shock. We find that after such a shock, the dollar significantly depreciates in future periods, consistent with our theory.

As the dollar co-movement with the stock market increases over longer horizons, our model predicts the propensity to issue dollar-denominated debt increases with debt maturity. We use granular bond-issuance data to test this prediction, and find strong support for it.

The sign change in the term structure of the dollar-stock market covariance (negative for short horizons, positive for long horizons) naturally raises the question of what would happen if the firm could rebalance its capital structure after a short-run dollar appreciation. To answer this question, we solve a dynamic version of our model with an intermediate period at which the firm can issue more debt or buy back debt in any currency. Our first result is that independent of the underlying shock dynamics, the firm never buys back debt, because doing so would mean foregoing the tax benefits. This result is a version of the leverage ratchet effect of [Admati et al. \(2018\)](#). Thus, when the firm issues long-term debt at time $t = 0$, it anticipates holding this debt all the way until expiry, making this part of the debt-choice problem effectively static. The next question is whether the possibility of issuing more debt at the intermediate period alters the currency composition of debt ex ante. Despite the extreme complexity of the dynamic capital-structure problem, we derive the optimal debt-issuance policy in closed form and uncover a novel *inter-temporal trade-off mechanism*. According to this mechanism, the firm chooses between receiving the tax benefits today and paying the (effective) cost of default tomorrow.

We characterize this novel trade-off explicitly in terms of the slopes of nominal yield curves across currencies and show the firm always selects the currency with the steepest yield curve. The dollar also fits this description better than other major currencies. In addition, we test a prediction of our model that the fraction of dollar-debt issuance co-moves positively with the difference in yield-curve slopes between the dollar and the euro (using the government bond yield curves in the US and Germany). Consistent with our theory, we find that, quite remarkably, regressing dollar-

debt issuance on this yield-curve slope differential produces statistically significant estimates with the predicted sign.

Finally, the COVID-19 crisis and ensuing developments in exchange-rate markets shed further light on our theory. Our theory suggests borrowers would prefer to issue debt in dollars if they expect it to depreciate in response to a global shock against other major currencies, in part due to easing by monetary policy. Following the COVID-19 shock, the Federal Reserve promptly and forcefully eased monetary policy and rolled out crisis programs. As a result, the dollar depreciated against all major international currencies. Unlike previous episodes, this depreciation happened almost immediately and to the order of around 10% in a few months. The depreciation of the dollar provided a material hedge for firms with nominal dollar debt as opposed to debt in euros, yen, or the Swiss francs. Moreover, inflation risk premia for the dollar increased compared with the euro. In this context, our theory predicts higher dollar-debt issuance in the post-COVID period.

We show evidence using granular issuance data that firms tended to issue more dollar debt than other major currencies in the aftermath of the COVID-19 crisis, controlling for other factors and firm fixed effects. The nature of the shock, the depreciation of the dollar, the impact of monetary policy, and the debt-issuance patterns in the aftermath of the COVID-19 crisis are all in line with the mechanisms discussed in our paper.

Related literature. Recent literature pays considerable attention to the international role of the dollar. The dollar is omnipresent in all parts of the global financial system (CGFS, 2020; Gopinath and Stein, 2021; Gourinchas, Rey, and Sauzet, 2019), including international trade invoicing (Goldberg and Tille, 2008; Gopinath, 2015; Gopinath et al., 2020), global banking (Shin, 2012; Ivashina, Scharfstein, and Stein, 2015; Aldasoro, Ehlers, and Eren, 2019), corporate borrowing (Bruno et al., 2018; Bruno and Shin, 2017; Giovanni et al., 2017), central bank reserve holdings (Bocola and Lorenzoni, 2020; Ilzetzi, Reinhart, and Rogoff, 2019), and global portfolios (Maggiori, Neiman, and Schreger, 2019). Our paper adds to the growing literature that studies the international role of the dollar.⁵

⁵See also, for example, Matsuyama, Kiyotaki, and Matsui (1993), Rey (2001), Caballero and Krishnamurthy (2002), Caballero, Farhi, and Gourinchas (2008), Caballero and Krishnamurthy (2009), Devereux and Shi (2013),

Our main contribution is the introduction of the “debt view” in explaining the international role of the dollar. Current explanations can be broadly classified into three categories. First is the “trade view,” wherein trade invoicing in dollars explains the dollar’s role in the global economy ([Gopinath and Stein, 2021](#)). Second is the “safe asset view,” in which the dollar is dominant because of its safe-haven properties ([He, Krishnamurthy, and Milbradt, 2019](#); [Farhi and Maggiori, 2018](#); [Jiang, Krishnamurthy, and Lustig, 2018](#)) and the global demand for safe assets ([Caballero, Farhi, and Gourinchas, 2008, 2015, 2017](#)). Third is the “vehicle currency view,” wherein the dominance of the dollar arises from its international use as a vehicle currency ([Goldberg and Tille, 2008](#)).

The debt view of the dollar’s dominance assigns an important role in the choice of the debt-currency denomination of firms, driven by *forward-looking expectations about exchange rates and monetary policy*. The main mechanism in our model is similar to the one in [Gomes, Jermann, and Schmid \(2016\)](#); but, in an international setting. The debt view focuses on the medium run to account for typical debt maturity of firms, and as such, complements other theories that focus on the short-run frictions such as price stickiness, or the short-run appreciation of the dollar in bad times as insurance to investors. In contrast to other theories, we show a dominant currency equilibrium in the debt market can arise without relying on network effects, price stickiness, pricing complementarities, and safety demand.

Three closely related papers to ours are by [Gopinath and Stein \(2021\)](#), [Jiang, Krishnamurthy, and Lustig \(forthcoming\)](#), [Liao \(2020\)](#), and [Bahaj and Reis \(2020b\)](#). [Gopinath and Stein \(2021\)](#) demonstrate how the dollar can emerge as a key international currency starting from its role in trade invoicing and in turn affecting global banking, which in turn affects the currency denomination of bank deposits and firm borrowing endogenously. Whereas their main focus is emerging markets and bank-intermediated debt, our results apply mostly for the currency choice of large, global firms and also apply to market-based financing, and the dollar’s dominant role arises due to its risk properties. [Jiang, Krishnamurthy, and Lustig \(forthcoming\)](#) find that investors attach a convenience yield for dollar safe assets that can be observed from covered interest parity deviations. An implication of their results is that firms would issue dollar debt to reap the benefits of this convenience yield.

[Chahrour and Valchev \(2017\)](#), [Mukhin \(2018\)](#), [Farhi and Maggiori \(2018\)](#), [He, Krishnamurthy, and Milbradt \(2019\)](#), [Drenik, Kirpalani, and Perez \(2019\)](#) and [Bahaj and Reis \(2020a\)](#).

[Liao \(2020\)](#) shows firms’ issuance flows of euro and dollar debt between the eurozone and the US respond to covered interest parity deviations. [Bahaj and Reis \(2020b\)](#) also assign an important role for monetary policy for the internationalization of currencies as in our paper, studying the Chinese renminbi’s jumpstart as an international currency. Our results complement the findings of these papers. We find firms choose the dollar as opposed to other currencies, regardless of the preferences of investors, and the issuance of dollar debt could be determined by its favorable risk properties over longer-horizons compared with other major currencies, such as the euro, the Japanese yen, or the Swiss franc. As we explain above, short-term safe-haven properties of the dollar do not contradict this finding.

A growing literature studies reasons for persistent uncovered interest rate parity (UIP) violations and its implications of these violations for the choice between local- and foreign-currency borrowing of emerging-market firms ([Baskaya et al., 2017](#); [Salomao and Varela, forthcoming](#)). Our primary interest lies in understanding why the dollar is the “dominant foreign currency” as opposed to similar currencies with similarly deep and liquid markets, such as the euro. Thus, we abstract from many features of currencies that lead to UIP deviations, in reality, to highlight our main mechanism, even though capturing these deviations in reduced form through differential issuance costs would be possible. In the Internet Appendix, we provide some theoretical and empirical results for the dominant and local currency mix in the debt of a cross-section of emerging-market firms that depend on the properties of local inflation and its relation to the US inflation.

Our paper is also related to the extensive literature on long-term nominal debt and its real effects, including debt deflation ([Fisher, 1933](#)), debt overhang ([Myers, 1977](#)), and leverage dynamics ([Gomes, Jermann, and Schmid, 2016](#)).

2. Theory

In this section, we build a simple model that lays out conditions for the currency choice of firms’ debt issuance. Our main theoretical result is that firms’ currency choice comes down to a simple statistic: the covariance between stock returns and exchange-rate returns. This covariance governs the choice of debt currency, regardless of the stochastic discount factor of lenders. In the

first part, we take exchange rates as given. In the second part, we add slightly more structure to exchange-rate determination, allowing us to assign a role for inflation and monetary policy in determining firms' currency choice. Although we take a partial-equilibrium approach in this paper for simplicity, in an earlier working-paper version, we solved the model in general equilibrium (Eren and Malamud, 2019). All results and intuitions go through in a general-equilibrium setting as well.

2.1. Model

Time is discrete, indexed by $t = 0, 1, \dots$. A large, international firm is infinitely lived and generates after-tax cash flows of $\Omega_t Z_t$, where Ω_t is the common productivity shock, which is measured in dollars, and Z_t is an idiosyncratic shock. If the firm generates cash flows in different currencies, we just multiply them with the respective exchange rates and then aggregate them to get the total dollar cash flows. We assume Z_t follows a geometric random walk, $Z_{t+1} = Y_{t+1} Z_t$, where Y_t are i.i.d. and have a density $P(Y_{t+1} = y) = \ell y^{\ell-1}$, $y \in [0, 1]$ and $\ell > 0$. This assumption is common in the literature on international trade (Melitz, 2003) and is made for tractability. We denote by $\Phi(y) \equiv P(Y \leq y) = y^\ell$ the cumulative distribution function of idiosyncratic shocks. All cash flows are priced with a common, exogenously given *dollar* stochastic discount factor $M_{t,t+1} = M_{t,t+1}^\$$. The choice of the dollar as the reference currency is made purely for tractability. See Lemma A.2 in the Internet Appendix, where we re-derive all expressions in the domestic currency.

Firms finance themselves by issuing both equity and defaultable nominal bonds in *any* of the N currencies, maturing in one time period.⁶ Each bond has a nominal face value of one currency unit, and the firm is required to pay a coupon of c currency units per unit of outstanding debt.⁷ We denote by $B_{j,t}$ the stock of outstanding nominal debt at time t denominated in the currency of country j . We also denote by $B_t = (B_{j,t})_{j=1}^N$ the vector of debt stocks in different currencies. That

⁶We interpret this one single period as the typical maturity of debt of the order of several years. See, for example, Cortina, Didier, and Schmukler (2018). The dollar is known to have a tendency to appreciate over the short term during crises (Maggiori, 2017; Farhi and Maggiori, 2018). So, some portion of the long-term debt may become due exactly during a crisis. We abstract from such considerations. Nonetheless, firms may keep dollar cash buffers to mitigate potential problems from the dollar's short-term risk profile.

⁷Apart from the multiple-currencies assumption, when modeling the financing side, we closely follow Gomes, Jermann, and Schmid (2016). However, our model is static. Empirical findings in Kalemli-Ozcan, Liu, and Shim (2018) suggest the effects of foreign-currency debt on firms' behavior might be even stronger in a dynamic setting.

is, $B_{j,t}$ is the *face value of debt in currency j to be paid back at time $t + 1$* . As in [Gomes, Jermann, and Schmid \(2016\)](#), we assume that coupon payments are shielded from taxes so that

$$\mathcal{B}_{t+1}(B_t) = ((1 - \tau)c + 1) \sum_{j=1}^N \mathcal{E}_{j,t+1} B_{j,t}$$

is the total debt-servicing cost, net of tax shields. Therefore, the choice of firm leverage depends on the trade-off between tax advantages and distress costs.⁸ Thus, absent default, the nominal distribution to shareholders at time $t + 1$ is given by

$$\Omega_{t+1} Z_{t+1} - \mathcal{B}_{t+1}(B_t) = Z_t \Omega_{t+1} Y_{t+1}.$$

If the idiosyncratic shock realization, $Y_{t+1} = Z_{t+1}/Z_t$, is below an endogenous default threshold $\Psi_{t+1}(B_t)$, shareholders optimally default on their debt. Upon default, shareholders get zero, and debtholders take over the firm and are able to recover a fraction $\rho < 1$ of debt face value and coupon.

Thus, the dollar value of cash flows to debtholders of currency- j debt are given by $(1 + c)(\mathbf{1}_{Y_{t+1} \geq \Psi_{t+1}} + \rho \mathbf{1}_{Y_{t+1} < \Psi_{t+1}}) \mathcal{E}_{j,t+1}$. Hence, by direct calculation, using the fact that the idiosyncratic shocks Y_{t+1} are independent of Ω_{t+1} , $M_{t,t+1}$, $\mathcal{E}_{j,t+1}$, we get that the dollar price of one unit of debt denominated in currency j is given by

$$\begin{aligned} \delta^j(B_t) &= E_t[M_{t,t+1}(\mathbf{1}_{Y_{t+1} \geq \Psi_{t+1}} + \rho \mathbf{1}_{Y_{t+1} < \Psi_{t+1}})(1 + c)\mathcal{E}_{j,t+1}] \\ &= E_t[M_{t,t+1}(1 - (1 - \rho)\Phi(\Psi_{t+1}(B_t)))(1 + c)\mathcal{E}_{j,t+1}], \end{aligned}$$

where $\Phi(\Psi_{t+1}(B_t))$ is the default probability conditional on the realization of aggregate variables.⁹

We assume that firms face a proportional cost $q(j)$ of issuing in country j currency for $j = 1, \dots, N$

⁸For simplicity, as in [Gomes, Jermann, and Schmid \(2016\)](#), we assume that tax shields are the only motivation for issuing debt. However, one can also interpret τ as a reduced form of gains from debt issuance, such as the alleviation of adverse-selection costs.

⁹Let $X_{t+1} = (\Omega_{t+1}, M_{t,t+1}, \mathcal{E}_{j,t+1})$. Then, by the law of iterated expectations,

$$\begin{aligned} E_t[M_{t,t+1}(\mathbf{1}_{Y_{t+1} \geq \Psi_{t+1}} + \rho \mathbf{1}_{Y_{t+1} < \Psi_{t+1}})(1 + c)\mathcal{E}_{j,t+1}] &= E_t[M_{t,t+1}(1 - \mathbf{1}_{Y_{t+1} \leq \Psi_{t+1}} + \rho \mathbf{1}_{Y_{t+1} < \Psi_{t+1}})(1 + c)\mathcal{E}_{j,t+1}] \\ &= E_t[M_{t,t+1}(1 - (1 - \rho)E[\mathbf{1}_{Y_{t+1} \leq \Psi_{t+1}}|X_{t+1}])](1 + c)\mathcal{E}_{j,t+1} = E_t[M_{t,t+1}(1 - (1 - \rho)\Phi(\Psi_{t+1}(B_t)))(1 + c)\mathcal{E}_{j,t+1}] \end{aligned}$$

and maximize equity value plus the proceeds from the debt issuance net of issuance costs. Although we do not micro-found these costs, doing so is not difficult. These costs may originate from underwriting costs, the limited risk bearing capacity of intermediaries (in the case of bank loans), or the actual debt placement costs incurred by the investment banks (e.g., locating bond investors). The observed convenience yields for dollar-denominated debt ([Jiang, Krishnamurthy, and Lustig, forthcoming](#)) can be viewed as a negative issuance cost $q(\$)$ in our model.

Conditional on no default, the equity value V_t of a given firm *after the previous period debt had been repaid* satisfies

$$V_t = \Omega_t Z_t + \max_{B_t} \left\{ \sum_{j=1}^N \delta^j(B_t) B_{j,t} (1 - q(j)) + E_t[M_{t,t+1} \max\{V_{t+1} - \mathcal{B}_{t+1}(B_t), 0\}] \right\}.$$

It is then straightforward to show equity value is homogeneous in Z_t , so that $V_t = Z_t \bar{\Omega}_t$ for some variable $\bar{\Omega}_t$ that is independent of idiosyncratic shocks. Thus, default occurs whenever Y_{t+1} falls below the default threshold

$$\Psi_{t+1}(B_t) \equiv \frac{\mathcal{B}_{t+1}(B_t)}{\bar{\Omega}_{t+1}},$$

Note that, importantly, Ψ_{t+1} is *invariant to currency choice*, because both the numerator $\mathcal{B}_{t+1}(B_t)$ and the denominator $\bar{\Omega}_{t+1}$ are denominated in dollars. In particular, the currency- k price of debt denominated in currency j satisfies $\delta^j(B_t, k) = E_t[M_{t,t+1}^k (1 - (1 - \rho)\Phi(\Psi_{t+1}(B_t)))(1+c)\mathcal{E}_{j,t+1}/\mathcal{E}_{k,t+1}]$ where $M_{t,t+1}^k = M_{t,t+1}^\$ \mathcal{E}_{k,t,t+1}$ is the pricing kernel in currency k .

Everywhere in the sequel, we use $E_t^\$$ and $\text{Cov}_t^\$$ to denote conditional expectation and covariance under the dollar risk-neutral measure with the conditional density $E_t[M_{t,t+1}]^{-1}M_{t,t+1}$. Furthermore, for each stochastic process X_t , we consistently use the notation

$$X_{t,t+1} \equiv \frac{X_{t+1}}{X_t}.$$

We need the following assumption to ensure that the leverage-choice problem has a non-trivial solution.

Assumption 1 *The (exogenously specified) issuance costs $q(j)$, $j = 1, \dots, N$ satisfy*

$$(1 - q(j))(1 + c) > (1 + c(1 - \tau)) \quad \text{and}$$

$$\bar{q}(j, \$) \equiv \frac{((1 - q(j))(1 + c) - (1 + c(1 - \tau)))}{(1 - \rho)(1 + c)[(1 - q(j)) + \ell(1 - q(\$))] - (1 + c(1 - \tau))} > 0$$

for all $j = 1, \dots, N$. We also define $\bar{q}(\$) \equiv \bar{q}(\$, \$)$.

The first condition ensures the cost $q(j)$ of issuing debt is less than the gains, as measured by the value of tax shields, so debt issuance is positive. The second condition ensures that the recovery rate ρ is sufficiently low; otherwise, funding becomes so cheap for the firm that the firm may want to issue infinite amounts of debt. The following is true.¹⁰

Theorem 2.1 *Issuing debt only in dollars is optimal if and only if*

$$\frac{\bar{q}(j, \$)}{\bar{q}(\$)} - 1 \leq \frac{\text{Cov}_t^\$ \left(\bar{\Omega}_{t+1}^{-\ell}, \mathcal{E}_{j,t,t+1} \right)}{E_t^\$ \left[\bar{\Omega}_{t+1}^{-\ell} \right] E_t^\$ [\mathcal{E}_{j,t,t+1}]} \quad (1)$$

for all $j = 1, \dots, N$. In this case, optimal dollar debt satisfies

$$B_{\$,t} = (1 + c(1 - \tau))^{-1} \left(\frac{\bar{q}(\$)}{E_t^\$ \left[\bar{\Omega}_{t+1}^{-\ell} \right]} \right)^{\ell^{-1}}.$$

Absent heterogeneity in issuance costs (i.e., when $q(j)$ is independent of j), (1) takes the form of

$$\text{Cov}_t^\$ \left(\bar{\Omega}_{t+1}^{-\ell}, \mathcal{E}_{j,t,t+1} \right) \geq 0, \quad j = 1, \dots, N. \quad (2)$$

¹⁰As we show in the Internet Appendix (see Proposition A.1), in our model, firms never hedge their foreign-exchange risk. Ample evidence shows firms often choose not to hedge their foreign-currency risk. See, for example, Bodnár (2006), who shows only 4% of Hungarian firms with foreign-currency debt hedge their currency risk exposure. Furthermore, according to Salomao and Varela (forthcoming), “data from the Central Bank of Peru reveals that only 6% of firms borrowing in foreign currency employ financial instruments to hedge the exchange rate risk, and a similar number is found in Brazil.” Du and Schreger (2017) also provide evidence that firms do not fully hedge their currency risk exposures. See also Niepmann and Schmidt-Eisenlohr (2019) and Bruno and Shin (2017). That being said, Liao (2020) does find evidence that at least 40% of global firms issue currency-hedged foreign debt. Although costly external financing is known to make hedging optimal (Froot, Scharfstein, and Stein, 1993; Hugonnier, Malamud, and Morellec, 2015), Rampini, Sufi, and Viswanathan (2014) show both theoretically and empirically that, in fact, more financially constrained firms hedge less. For more on hedging, see Section 3.4..

Intuitively, at time t , firms, when deciding on the currency composition of their debt, choose to issue in dollars if they expect the dollar to depreciate when their time $t + 1$ valuation is low; condition (2) provides a precise formalization of this intuition. Because $(\bar{\Omega}_{t+1})^{-\ell}$ attains its largest value when $\bar{\Omega}_{t+1}$ is close to zero, covariance (2) overweights the distress states: when ℓ is sufficiently high, (2) essentially requires the dollar to depreciate against all its key competitors during times of major economic downturns.

Also note condition (2) corresponds to the problem a firm faces when choosing between dollar debt and debt denominated in other key currencies, such as, for example the euro, the yen, the Swiss franc, and the pound. For an emerging-market firm that is choosing between local-currency debt and dollar debt, heterogeneity in issuance costs may be as (if not more so) important as the currency risk profile. However, even for the choice between dollar- and euro-denominated debt, ignoring differences in issuance costs puts the dollar at a disadvantage: Existing evidence (Velandia and Cabral, 2017) suggests issuing debt in dollars is significantly cheaper than issuing in euros. The convenience yield on the dollar also effectively implies negative issuance costs for dollar-denominated debt (Jiang, Krishnamurthy, and Lustig, forthcoming; Liao, 2020).

To test the validity of condition 1, we need to find an empirical proxy for $\bar{\Omega}_t$. We suppose for simplicity that the distressed state only lasts for one period, and debt holders run the firm inefficiently, making its output drop. We call this drop “Distress Costs.” The following is true.

Proposition 2.2 *Let S_t be the (value-weighted) stock market index (i.e., total market capitalization of all (large and diversified) firms). Then,*

$$S_t = \bar{\Omega}_t - \text{Distress Costs}_t.$$

Proposition 2.2 shows that $\bar{\Omega}_t$ is closely related to the market portfolio. If distress costs are small relative to the total value of the stock index, then $\bar{\Omega}_t$ can be directly proxied by the corresponding stock market index of “similar” firms. We therefore use stock market index returns in our empirical tests of condition (2).

2.2. Roles for Inflation and Monetary Policy

In this section, we derive a link between the characterization in Theorem 2.1 and the inflation risk premium and assign a role for monetary policy in determining the dominant currency in debt issuance.

Denote by $\mathcal{P}_{i,t}$ inflation in country i , $i = 1, \dots, N$. We make the following assumptions about the joint long-term dynamics of inflation and exchange rates at horizons of average debt maturity.

Assumption 2 *A global business-cycle shock, a_t , exists such that*

- *Relative PPP is an important driver of exchange rates:*

$$\mathcal{E}_{j,t,t+1} = \mathcal{P}_{\$,t,t+1} \mathcal{P}_{j,t,t+1}^{-1} e^{\varepsilon_{j,t+1}^*}$$

where $\varepsilon_{j,t+1}^* \sim N(0, \sigma_{i,*}^2)$ are the log real exchange rates.

- *Stochastic discount factor is countercyclical,*

$$\log M_{t,t+1} = -\gamma a_{t+1} + \varepsilon_{t+1}^M,$$

where $\varepsilon_{i,t+1}^M \sim N(0, \sigma_M^2)$.

- *Stock prices are cyclical*

$$\log S_{i,t,t+1} = \beta_i a_t + \varepsilon_{i,t}^S,$$

where $\varepsilon_{i,t}^S \sim N(0, \sigma_S^2)$ and $\beta_i > 0$.

- *All variables a_t , $\varepsilon_{i,t}^M$, $\varepsilon_{j,t}^*$, $\varepsilon_{i,t}$, ε_t^S are independent.*

Under Assumption 2, a key driver of debt-currency choice will be forward-looking expectations about the co-movement of inflation with the stock market. The latter can be backed out from the inflation risk premium, given by the difference between inflation expectations under the risk-neutral

and the physical measures:

$$IRP_{i,t} = \log \left(\frac{E_t^i[\mathcal{P}_{i,t,t+1}]}{E_t[\mathcal{P}_{i,t,t+1}]} \right) = \log \left(\frac{e^{r_t} \text{Cov}_t(M_{i,t,t+1}, \mathcal{P}_{i,t,t+1})}{E_t[\mathcal{P}_{i,t,t+1}]} \right).$$

The following is true.

Theorem 2.3 *Under Assumption 2, firms issue all debt in US dollars if and only if the US has the highest inflation risk premium.*

Although Assumption 2's requirements to derive Theorem 2.3 is restrictive, they allow us to highlight the important link between our results and Fisherian debt-deflation theory (Fisher, 1933). The common-shock structure in Assumption 2 allows us to abstract from the choice between local-currency and foreign-currency debt, and focus on the choice between different global currencies (e.g., the euro and the dollar).

3. Evidence from forward-looking measures

The first goal of this section is to check whether the risk properties of the dollar fit the predictions of our theory of the dominant currency using forward-looking measures of the covariance between the stock market returns and exchange rates. The second goal is to understand the pre- and post-crisis trends in the shares of euro- and dollar-denominated debt through the lens of our model.

An ideal test of our predictions would be to test the following condition:

$$\frac{\bar{q}(j, \$)}{\bar{q}(\$)} - 1 \leq \frac{\text{Cov}_t^{\$} \left((\bar{\Omega}_{t+1})^{-\ell}, \mathcal{E}_{j,t,t+1} \right)}{E_t^{\$} [(\bar{\Omega}_{t+1})^{-\ell}] E_t^{\$} [\mathcal{E}_{j,t,t+1}]}.$$

According to our model, abstracting from differences in issuance costs, the currency that *market participants expect to co-move* more with the stock market would be the currency firms would choose to denominate their debt. We show, using forward-looking risk premia recovered from asset prices, that the dollar fits this description.

Moreover, if the distribution of issuance costs stays roughly constant across firms, our model implies a tight link between the time variation in this anticipated co-movement and the currency

denomination of debt issuance. In particular, all else constant, our model would attribute the recent rise in the share of dollar-denominated debt to heightened expectations of market participants of the dollar becoming more positively (or less negatively) correlated with the stock market than the euro over longer horizons. By extension, the dollar becomes more of a hedge for long-term borrowers rather than investors. We provide evidence for the link between debt-issuance patterns and such forward-looking market expectations and find support for the debt view, suggesting firms issue more dollar debt when the dollar becomes riskier from the investors' point of view.

3.1. *Quanto-implied risk premia and inflation risk premia*

A direct way to compute the forward-looking covariance between the stock market and exchange rates is to use so-called quanto forward contracts (Kremens and Martin, 2019), which provides an almost ideal test of our theory. A euro-quanto forward contract for S&P 500 with maturity T , for example, pays off the level of the S&P 500 index *in euros*. Therefore, at initiation, the exchange rate is fixed. As opposed to a contract that pays off the S&P 500 in dollars, the value of this contract depends on the anticipated covariance between the index and the EUR/USD exchange rate.

Hence, the price of this contract reflects the expectations of investors about currency returns. For example, if a quanto contract on the S&P 500 denominated in euros is more valuable than the S&P 500 denominated in dollars, the implication is that investors expect the euro to depreciate when the index (in dollars) is low, and vice versa.

Formally, we define the quanto-implied risk premium (QRP) as:

$$QRP_t = \text{Cov}_t^{\$} \left(S_{t+1}, \frac{EUR}{USD} \right) = \frac{R_{f,t}^{\$}}{R_{f,t}^i P_t} (Q_t - F_t), \quad (3)$$

where Q_t and F_t are quanto and vanilla forward prices, respectively.

Using the approximation

$$\text{Cov}_t^{\$} \left(S_{t+1}^{-\ell}, \frac{EUR}{USD} \right) \approx -\ell \text{Cov}_t^{\$} \left(S_{t+1}, \frac{EUR}{USD} \right),$$

we can transform the QRP measure into the covariance we derived in the previous section. Namely, a negative QRP means investors expect the dollar to depreciate against the euro when the S&P 500 falls.

Kremens and Martin (2019) compute the quanto-implied covariance for contracts with a two-year maturity and find the quanto-implied covariance of the EUR/USD exchange rate with S&P 500 exhibited a very strong downward trend in the post-crisis period and has become negative in the recent years (Fig. 2). This evidence is perfectly in line with the predictions of the debt view.

Whereas quanto-implied covariance is the most relevant measure for our purposes, data obtained from Kremens and Martin (2019) only cover the period between December 2009 and October 2015. Because our goal is to explain the fall and the rise of the dollar in debt markets over the last two decades, we also resort to a longer time series containing similar information about forward-looking covariances. We use our model to generate similar predictions that we can test with other available data measuring forward-looking risk premia. A second limitation of the QRP data is that liquid quanto contracts only exist for maturities of two years and less. To remedy that limitation, we provide further evidence for the covariance over longer horizons using backward-looking measures in Section 4. Finally, quanto contracts give us information about the covariance of the exchange rate and the S&P 500. Because our theory mainly applies to global firms that are exposed mostly to global shocks, we believe the S&P 500 provides a proxy. In Section 4, we also provide backward-looking evidence on the covariances using the MSCI All Country World Index.

To obtain long time series containing information about forward-looking covariances, we appeal to Theorem 2.3, which provides a direct link between debt-currency denomination and anticipated *relative* inflation cyclicalities under the assumption that relative PPP is an important determinant of exchange rates at horizons of average debt maturity.¹¹

The explicit link between relative inflation dynamics and exchange rates is the key element behind Theorem 2.3. Consistent with the predictions of Theorems 2.1 and 2.3, both QRP and IRP measures point to the dollar being the dominant currency in the post-crisis period. The left

¹¹Although the perfect link between exchange rates and inflation relies on a strong form of PPP, Theorem 2.3 would still hold true even with large PPP deviations, as long as the relative-inflation component of the exchange rates contributed significantly to the covariance (2) over the horizons of debt maturity of a typical firm. See Chernov and Creal (2021) for evidence that PPP is an important driver of long-horizon currency risk premia.

panel of Fig. 2 shows the quanto-implied risk premium for the EUR/USD exchange rate taken directly from Kremens and Martin (2019). The right-hand panel of Fig. 2 shows the inflation risk premia for the euro and the dollar for two years and for five years, taken directly from Hördahl and Tristani (2014).¹² As we can see from this figure, in recent years, QRP entered the negative territory, whereas the dollar IRP went up relative to the euro QRP. Finally, note that Theorem 2.3 does not require US inflation to be countercyclical: what matters is the *relative inflation dynamics between the two countries*. Even if US inflation is procyclical, firms will still issue in dollars if they expect euro inflation to be lower US inflation in bad times.

In a recent paper, Campbell, Pflueger, and Viceira (2020) find US inflation became procyclical after 2001 [see also Baele, Bekaert, and Inghelbrecht (2007)]. The fact that the dollar has a higher IRP than the euro in the post-crisis period suggests that investors anticipate US inflation to be less procyclical than that in the Eurozone. Note also Campbell, Pflueger, and Viceira (2020) investigate inflation cyclicity over short horizons below one year. Our estimates of the covariance of CPI changes with stock market returns suggest that this covariance is consistently negative at horizons beyond three years; that is, inflation is countercyclical at horizons of debt maturity.

3.2. *The fall and the rise of the dollar*

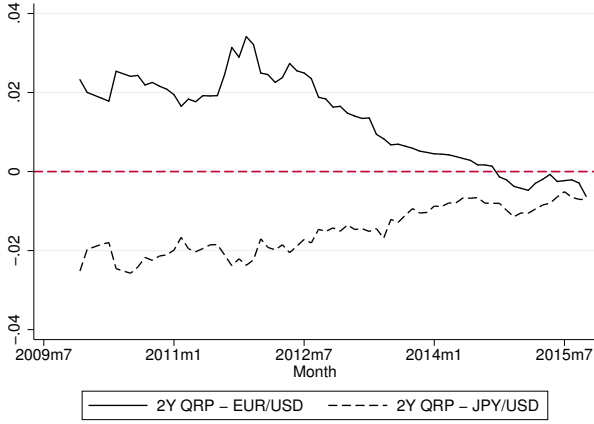
In this section, we state and test two predictions linking QRP and IRP dynamics with the currency denomination of debt issuance. We start with the following important result.

Proposition 3.1 *If the distribution of debt-issuance costs across firms is constant over time, the quanto-implied covariance (3) is **negatively** related to the share of dollar-denominated debt issuance.*

Proposition 3.1 is a direct consequence of Theorem 2.1: when (3) drops, the fraction of firms

¹²The same pattern is present for longer maturities. Moreover, the difference between the dollar and the euro is more pronounced for longer maturities.

2-Year QRP



2- and 5-Year IRP

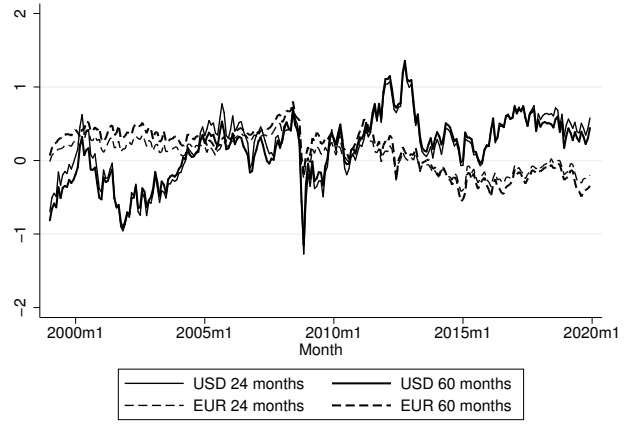


Fig. 2. Two-year quanto-implied risk premia and two- and five- year inflation risk premia in the US and eurozone. Source: QRP data are from [Kremens and Martin \(2019\)](#) and IRP data are from [Hördahl and Tristani \(2014\)](#).

for which (1) holds increases, and hence, so does the dollar issuance.¹³ An analogous result holds for IRP¹⁴.

Proposition 3.2 *Under Assumption 2, if the distribution of debt-issuance costs across firms is constant over time, then the dollar debt share is **positively** related to the dollar IRP and is **negatively** related to the euro IRP.*

In Fig. 3, we show the volume and the currency composition of gross issuance patterns

¹³Note that even if the quanto-implied covariance (3) is positive (as it was before 2015), firms may still prefer issuing in dollars as long as doing so is cheaper than issuing in euros. For example, according to [Velandia and Cabral \(2017\)](#), “In the case of Mexico, the average bid-ask spread of the yield to maturity on outstanding dollar-denominated international bonds is seven basis points, compared to 10 basis points for outstanding euro-denominated bonds. Mexico is also an example with very liquid benchmarks on both currencies.” The dollar convenience yield further amplifies this effect ([Jiang, Krishnamurthy, and Lustig, forthcoming](#)).

¹⁴In our model, IRP can be viewed as a barometer of market expectations about inflation cyclicalities. Although our model is silent about the origins of these expectations, one might speculate that the observed pattern in inflation risk premia between the euro and the dollar, shown in Fig. 2, may be due to declining expectations of inflation stabilization and an increasing expected risk of deflation in the eurozone following the Global Financial Crisis in 2008 and the European Debt Crisis in 2011.

of international debt as well as the shares of the dollar and the euro obtained from the BIS International Debt Securities statistics (data includes all sectors except the government).

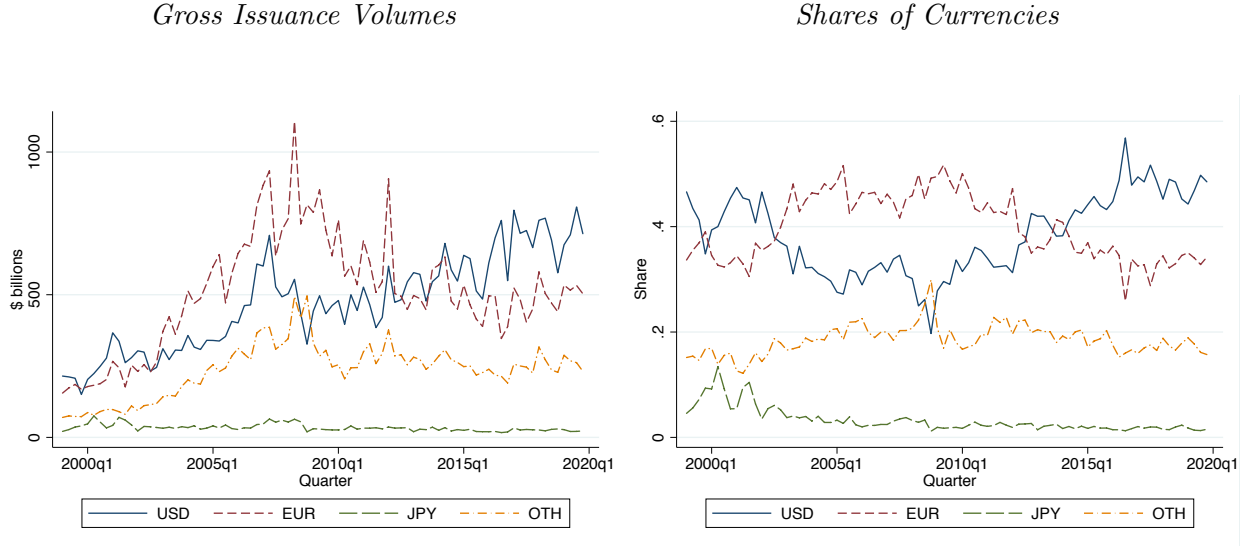


Fig. 3. Gross issuance of international debt securities. Source: BIS International Debt Securities.

Broad trends shown in Fig. 1 for amounts outstanding, in Fig. 3 for debt issuance, and in Maggiori, Neiman, and Schreger (2019) for corporate debt holdings seem to be aligned with the trends in QRP and IRP documented in Fig. 2. These joint dynamics of risk premia and dollar-debt quantities lend support to the debt view (Predictions 3.1 and 3.2). In particular, in the pre-crisis period, IRP for the euro was higher than the IRP for the dollar, and after the crisis, this relationship reversed. In line with our predictions, the share of dollar debt was in decline before the crisis and increased after the crisis. Moreover, during the period for which we have data, the QRP of the euro against the dollar declined strongly.

Both the QRP and the IRP dynamics suggest that debt holders caring about inflation and foreign-exchange risk should dislike holding dollar-denominated debt and prefer holding euro-denominated debt in the post-crisis period. However, the debt view implies firms will still prefer to issue debt in dollars because of the attractive risk properties of the dollar.

3.3. QRP, IRP, and debt-issuance dynamics

Whereas broader trends in debt-currency choice and currency and inflation risk premia are in line with our predictions, we would now like to formally test Propositions 3.1 and 3.2 about the response of dollar-debt issuance to movements in risk premia. One distinctive feature of our theory is that changes to debt-issuance currency are driven by expectations and could change quickly. We regress various measures of the dollar's share in debt markets on changes in risk premia at a quarterly frequency. First, we test Proposition 3.1: as the euro becomes less of a hedge for firms, that is, as QRP declines, do they issue more dollar debt? Second, we test Proposition 3.2: as the euro IRP becomes lower than the dollar IRP, do firms issue more dollar debt?

Table 1.
QRP, IRP, debt-currency choice

Robust standard errors are shown in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively. Debt-issuance data includes all sectors except the government. Latest observed values of $QRP_{\$/\$,t}^{2Y}$, $IRP_{\$,t}^{2Y}$, and $IRP_{\$,t}^{2Y}$ in a given quarter are used. $QRP_{\$/\$,t}^{2Y}$ data come from Kremens and Martin (2019), and $IRP_{\$,t}^{2Y}$ and $IRP_{\$,t}^{2Y}$ are recovered using the methodology in Hördahl and Tristani (2014). Trend refers to a linear time trend and control refers to the inclusion of total issuance as a control variable.

	(1)	(2)	(3)	(4)	(5)	(6)
Sample:	Full	Full	Full	Full	Full	Full
	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}
$QRP_{\$/\$,t}^{2Y}$	-3.463*** (0.314)	-1.574** (0.680)	-3.505*** (0.305)			
$IRP_{\$,t}^{2Y}$				-0.00612 (0.0197)	-0.00870 (0.0254)	0.0330 (0.0232)
$IRP_{\$,t}^{2Y}$				-0.201*** (0.0266)	-0.194*** (0.0406)	-0.200*** (0.0251)
Trend		X			X	
Control			X			X
Period	09q4-15q3	09q4-15q3	09q4-15q3	99q1-19q4	99q1-19q4	99q1-19q4
Observations	24	24	24	84	84	84
R-squared	0.713	0.783	0.781	0.340	0.341	0.449

We report the results in Table 1. Column (1) shows a one-standard-deviation decrease in $QRP_{\$/\$,t}^{2Y}$, which is around 0.01, is associated with around three-percentage-points-higher dollar share in debt issuance in a given quarter. Note the average of the total issuance is \$1.284 trillion. Hence, three percentage points amount to around \$38 billion in a quarter. In column (2), we rerun the regression with a linear time trend, and in column (3), we control for total issuance. The results are qualitatively similar. In columns (4), (5), and (6), we rerun the same type of regressions for the dollar share in debt issuance and inflation risk premia in the US and the eurozone. The results suggest that whereas debt-issuance patterns do not move much with inflation risk premia in the US, they mostly react to the inflation-risk-premia movements in the eurozone. Thus, the decline of the euro as a preferred currency for debt issuance might be due to rising deflation risk in the eurozone after the European sovereign debt crisis. The magnitude is also sizable as the results suggest a one-standard-deviation decrease in the eurozone IRP (which is 0.02) corresponds to around four-percentage-point-higher dollar share in debt issuance.¹⁵

The above regression results provide additional support for our theory. Moreover, the effects we identify hold in a relatively high frequency, lending support to another prediction of our theory: changes in the currency of debt issuance respond to expectations and therefore could occur relatively quickly.

3.4. *Exchange-rate expectations or convenience yield: What drives debt-issuance dynamics?*

Issuing dollar-denominated debt is cheap, not only due to more liquid markets and lower underwriting costs (Velandia and Cabral, 2017), but also due to significant investor demand for dollar assets that creates a convenience yield for dollar-denominated safe assets (Jiang, Krishnamurthy, and Lustig, forthcoming). Liao (2020) computes a measure that captures the FX-hedged corporate borrowing-cost differential, *the corporate basis*, which is effectively the convenience yield of dollar-denominated corporate debt. A higher corporate basis between the dollar and the euro means borrowing in dollars is cheaper than borrowing in euros, making the dollar-issuance cost $q(\$)$ in equation (1) effectively negative. When this basis is changing over time, a direct analog of

¹⁵In the Appendix, we report the results for non-bank and bank debt issuance separately. The results are similar for both sectors.

Proposition 3.1 implies dollar-debt-issuance dynamics could potentially be driven both by the corporate basis and the hedging properties of the dollar.

In this section, we rerun the regressions in Table 1, also controlling for the corporate basis to explain the dynamics of the global dollar share of debt issuance. We report the results of this regression in Table 2, which shows the signs on QRP and IRP and their statistical significance remain unchanged, lending further support to the debt view. Moreover, the sign of the coefficient on the corporate basis is negative (i.e., “the wrong sign”), suggesting that, in aggregate, fluctuations in the convenience yield do not drive debt-issuance dynamics.

Table 2.

QRP, IRP, corporate basis, and debt-currency choice: exchange-rate expectations versus convenience yield.

Robust standard errors are shown in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively. Debt-issuance data includes all sectors except the government. The latest observed values of $QRP_{\$/\$,t}^{2Y}$, $IRP_{\$,t}^{2Y}$, and $IRP_{\$/\$,t}^{2Y}$ in a given quarter are used. $QRP_{\$/\$,t}^{2Y}$ data come from Kremens and Martin (2019), $IRP_{\$,t}^{2Y}$ and $IRP_{\$/\$,t}^{2Y}$ are recovered using the methodology in Hördahl and Tristani (2014), and $Corp.Basis_t$ data come from Liao (2020). Different sample periods are due to differences in data availability, and multiple columns provide robustness checks by aligning sample periods.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}
$QRP_{\$/\$,t}^{2Y}$	-3.463*** (0.314)			-1.566** (0.718)			
$Corp.Basis_t$		-0.00113 (0.000786)	-0.00295*** (0.000450)	-0.00182** (0.000772)			-0.000846* (0.000451)
$IRP_{\$,t}^{2Y}$					-0.00612 (0.0197)	0.0393 (0.0259)	0.0435* (0.0251)
$IRP_{\$/\$,t}^{2Y}$					-0.201*** (0.0266)	-0.192*** (0.0239)	-0.186*** (0.0232)
Period	09q4-15q3	03q4-16q2	09q4-15q3	09q4-15q3	99q1-19q4	03q4-16q2	03q4-16q2
Observations	24	51	24	24	84	51	51
R-squared	0.713	0.053	0.747	0.783	0.340	0.527	0.555

4. Evidence from backward-looking measures

Our key theoretical condition posits that firms prefer to issue in dollars if they expect the dollar exchange rate to positively co-move with their stock market returns over their debt-maturity horizons.¹⁶ Whereas the quanto-implied QRP is the ideal empirical measure of such forward-looking expectations, the most extended maturity of liquid quanto contracts is two years, and the average debt maturity of a firm is typically much longer. In this subsection, we investigate backward-looking measures of the dollar-stock market co-movement, arguing that rational agents might use these measures as a basis for their forward-looking expectations.

We use two stock market indices to test our predictions, namely, the S&P 500 and the MSCI AC World Index measured in dollars, to be consistent with our theoretical conditions. For this subsection, we use the trade-weighted dollar index against major currencies, including those in eurozone, Canada, Japan, the UK, Switzerland, Australia, and Sweden, as obtained from the FRED database.¹⁷ We conduct our analysis by first looking at simple covariances, then through a VAR analysis to gauge the lead-lag relationships between stock indices and the dollar. In the Internet Appendix, we also provide results using the bilateral exchange rates between the dollar and the euro,¹⁸ the yen, the pound, and the Swiss franc.

4.1. *Why is the dollar the dominant currency? Results with the dollar index*

Given that the dollar is the most common currency of denomination in international debt markets, the first prediction of our model is that the returns on the dollar index positively correlate with the returns on the stock market indices at horizons that correspond to the typical debt maturity [see Section 5, Choi, Hackbarth, and Zechner (2018); Cortina, Didier, and Schmukler (2018)]. To test this prediction, we first run the following regressions for the horizons of $h \in$

¹⁶In fact, given that issuing in dollars is cheaper than issuing in any other currency, condition (1) implies that firms would issue all their debt in dollars even if this correlation were negative, but not too negative relative to the cost gain of issuing in dollars.

¹⁷Our results are robust when we use other indices such as the narrow or the broad dollar index obtained from the BIS.

¹⁸We use the Deutsche mark prior to the introduction of the euro using the euro/Deutsche mark exchange rate at the time of the inception of the euro.

$\{3, 12, 24, 36, 48, 60, 72, 84, 96, 108, 120\}$ months:¹⁹

$$Ret_USD_{t-h,t} = \alpha^h + \beta_h Ret_StockIndex_{t-h,t} + \epsilon_{t-h,t}. \quad (4)$$

Here, $Ret_USD_{t-h,t}$ and $Ret_StockIndex_{t-h,t}$ denote the rolling (overlapping) returns on the dollar index and the two indices we use (in two separate regressions) over h months, respectively. Fig. 4 reports the results for the regression coefficient β_h for different horizons and for different stock market indices, together with the 95% confidence intervals. The sample period for the MSCI series starts in January 1988. The round dots and the corresponding solid lines in both panels represent the point estimates and 95% confidence intervals obtained using a sample period between January 1988 and December 2019. The squared dot and the corresponding dashed lines on the left-hand panel represent the point estimates and 95% confidence intervals obtained using a sample period between January 1973 and December 2019 for the S&P 500 and the FRED dollar index.

The results show a pattern of negative betas at short horizons and positive and mostly increasing betas at longer horizons. The negative betas for shorter horizons are consistent with the findings in [Gourinchas, Govillot, and Rey \(2017\)](#) and [Gourinchas \(2019\)](#), who show the dollar tends to appreciate in bad times.²⁰ However, Fig. 4 suggests the sign of the relationship reverts for typical horizons of debt maturity.²¹ These findings, together with condition (2), suggest global firms, whose stock returns co-move with the S&P 500 or the MSCI AC World Index, are better off if they borrow in dollars rather than in other major international currencies if their debt maturity is sufficiently long.

In the Internet Appendix, we repeat the same exercise with non-overlapping observations. Whereas the statistical significance is hard to establish in that case due to a remarkable drop

¹⁹We then control for autocorrelation at the respective horizons by using the Newey-West correction with the respective number of lags.

²⁰In this paper, we focus on the choices of firms and hence the medium run risk properties of the dollar, and abstract from frictions that households face. However, one can argue that in a more realistic model with more frictions and differences in relevant horizons between households and firms, the short-run appreciation in bad times provides insurance to investors with shorter horizons and safety demand, and the medium-run depreciation of the dollar provides insurance to firms with longer maturity nominal debt, thereby reinforcing the dominant international role of the dollar.

²¹Interestingly enough, the same pattern of sign reversal at longer horizons is also observed in the behavior of UIP deviations. See [Valchev \(2015\)](#) and [Engel \(2016\)](#). Understanding the links between these findings and our results is an interesting direction for future research.

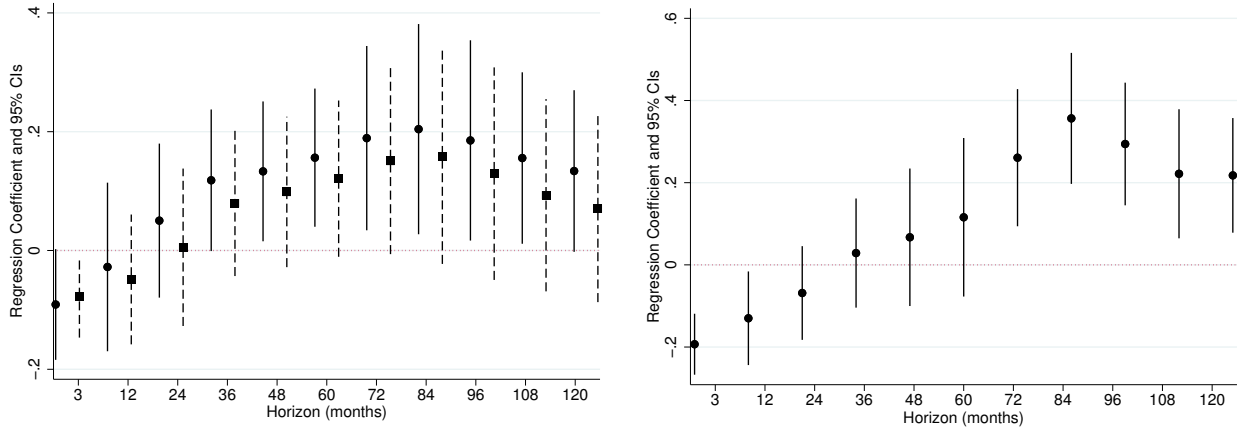


Fig. 4. The betas of the USD index returns with respect to stock market returns. The graphs report the regression coefficients β_h from the regressions (4). Standard errors are corrected using the Newey-West procedure with the number of lags being equal to the horizon h of returns for each respective regression. The round dots and the corresponding solid lines in both panels represent the point estimates, β_h , and 95% confidence intervals obtained using a sample period between January 1988 and December 2019. The squared dot and the corresponding dashed lines on the left-hand panel represent the point estimates, β_h , and 95% confidence intervals obtained using a sample period between January 1973 and December 2019 for the S&P 500 and the FRED dollar index.

in sample sizes, the pattern of short-term negative dollar betas, followed by positive betas at longer horizons, is present in that exercise as well.

Why does the sign of the co-movement between the dollar index and the stock market change for longer horizons? To answer this question, we decompose the covariance between the dollar and the stock market based on the additivity of log-returns: $Ret_{t-h-j,t} = R_{t-h-j,t-h} + R_{t-h,t}$ for

any pair $h, j > 0$. Using this decomposition, we get that

$$\begin{aligned}
& \text{Cov}(Ret_USD_{t-h-j,t}, Ret_SP500_{t-h-j,t}) \\
&= \underbrace{\text{Cov}(Ret_USD_{t-h-j,t-h}, Ret_SP500_{t-h-j,t-h}) + \text{Cov}(Ret_USD_{t-h,t}, Ret_SP500_{t-h,t})}_{co-movement} \\
&+ \underbrace{\text{Cov}(Ret_USD_{t-h-j,t-h}, Ret_SP500_{t-h-j,t})}_{USD \text{ leading } S\&P500} + \underbrace{\text{Cov}(Ret_SP500_{t-h-j,t-h}, Ret_USD_{t-h,t})}_{S\&P500 \text{ leading } USD}.
\end{aligned} \tag{5}$$

Because the co-movement terms in the covariance decomposition are negative for shorter horizons, whereas the total covariance is positive for longer horizons (see Figure 4), at least one of the lead-lag terms in (5) must be positive and sufficiently large to offset the negative co-movement terms.

4.2. VAR Analysis

To understand the impact of the lead-lag relationships in (5) on the joint dynamics of the dollar and S&P 500, we estimate the following two-lag VAR model at annual frequency (selected based on the standard Akaike information criterion (AIC)):

$$\begin{pmatrix} Ret_USD_{t-1,t} \\ Ret_SP500_{t-1,t} \end{pmatrix} = \Psi \begin{pmatrix} Ret_USD_{t-2,t-1} \\ Ret_SP500_{t-2,t-1} \end{pmatrix} + \Gamma \begin{pmatrix} Ret_USD_{t-3,t-2} \\ Ret_SP500_{t-3,t-2} \end{pmatrix} + \varepsilon_t,$$

where $\Psi = \begin{pmatrix} \Psi_{1,1} & \Psi_{1,2} \\ \Psi_{2,1} & \Psi_{2,2} \end{pmatrix}$ and $\Gamma = \begin{pmatrix} \Gamma_{1,1} & \Gamma_{1,2} \\ \Gamma_{2,1} & \Gamma_{2,2} \end{pmatrix}$ and $\varepsilon_t \sim N(0, \Sigma)$ for some 2×2 covariance matrix Σ .

The results of this VAR are reported in Table 3. We find $\hat{\Psi}_{1,2} > 0 > \hat{\Sigma}_{1,2}$, so that the dollar and S&P 500 co-move negatively contemporaneously, but the lagged return on the S&P 500 positively

predicts the dollar.²² This finding is consistent with the decomposition (5) and Fig. 4: This lead-lag relationship is responsible for the sign change in Fig. 4 at longer horizons.²³

Table 3.

A VAR(2) model of the S&P 500 and the FRED dollar index.

Standard errors that are adjusted for small-sample degrees of freedom are in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively. The coefficients are from a VAR(2) model of non-overlapping annual returns on the S&P 500 and the FRED dollar index against major currencies (DTWEXM) between 1973 and 2019.

	(1)	(2)
	$Ret_SP500_{t-1,t}$	$Ret_USD_{t-1,t}$
$Ret_SP500_{t-2,t-1}$	-0.0856 (0.147)	0.122* (0.0661)
$Ret_SP500_{t-3,t-2}$	-0.202 (0.146)	0.0494 (0.0657)
$Ret_USD_{t-2,t-1}$	0.310 (0.335)	0.322** (0.151)
$Ret_USD_{t-3,t-2}$	-0.240 (0.329)	-0.291** (0.148)
Observations	45	45
R-squared	0.0714	0.2073

Next, we use our estimates from the VAR model to compute the cumulative impulse response of both the dollar and the S&P 500 following a negative shock to the S&P 500. As one can see from Fig. 5, the cumulative impact of a negative shock to the S&P 500 on the dollar is a significant depreciation at a 5% level two and six years following the shock and a significant depreciation at a 10% level for most horizons.²⁴ In the Internet Appendix, we report the VAR regressions results for

²²Although the results are statistically significant at the 10% level for the entire sample 1973-2019, our early sample was characterized by the end of the Bretton Woods era and the associated outlier of event of extreme dollar depreciation. If we restrict our sample to 1976-2019, the coefficient is 0.15, significant at 5% level. In the paper, we report the results using the entire sample of available data; however, results based on different sample periods are available upon request.

²³The variance-covariance matrix for the error terms is estimated as: $\hat{\Sigma} = \begin{pmatrix} 0.0256 & \\ -0.0016 & 0.00516 \end{pmatrix}$.

²⁴Similar to the VAR coefficients, the impulse responses are also stronger if we restrict the period to 1976-2019, with statistical significance at 5% for almost all horizons. These results are also available upon request.

the MSCI World Index (for which we have data from 1988 onwards). The results are qualitatively similar, but stronger and statistically significant at the 5% level for the MSCI World Index - in part also reflecting the stronger relationship in the later sample periods reported in Fig. 4.

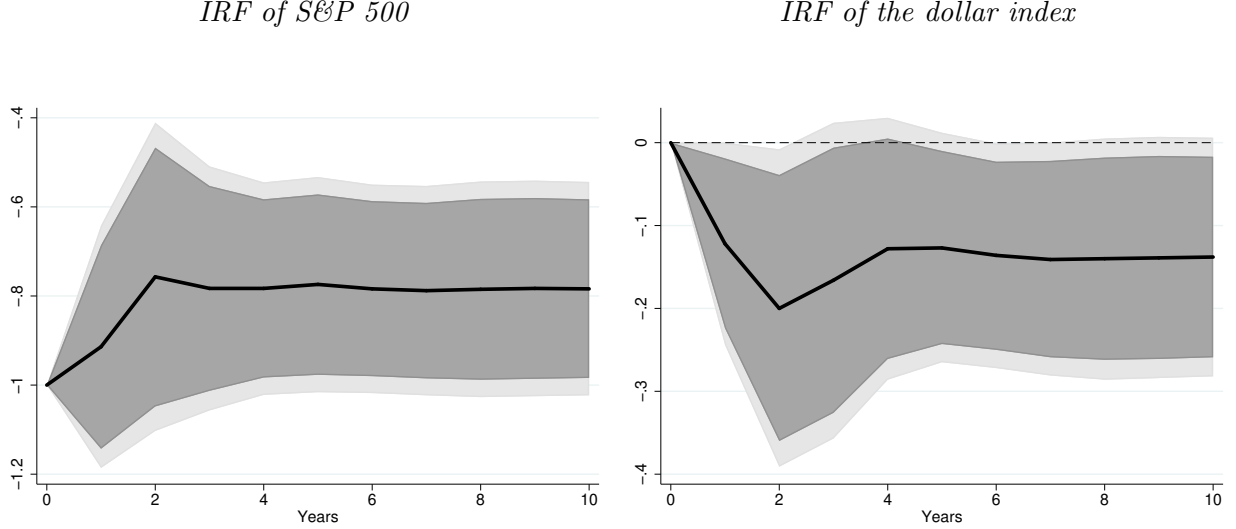


Fig. 5. Cumulative Impulse-Response Functions of a Shock to S&P 500. Figures show the cumulative impulse-response functions of a negative 1 ppt shock to the S&P 500 based on the estimates of a VAR(2) model of the yearly returns on the S&P 500 and the FRED dollar index against major currencies (DTWEXM) between 1973 and 2019, reported in Table 3. The lines in each graph represent the cumulative impulse-response functions. The darker shaded areas represent the 90% confidence intervals, and the lighter shaded areas represent the 95% confidence intervals. Source: Datastream, FRED, authors' calculations.

Fig. 5 complements Fig. 4, providing additional evidence for longer-run co-movement between the dollar and stock market. Whereas historical covariance estimates in Fig. 4 are based on overlapping returns, our VAR model is estimated with non-overlapping returns, allowing us to leverage a longer sample. All in all, despite significant small-sample issues, our results based on historical data point toward the same direction: The choice of the dollar over other major currencies by debt issuers is consistent with the empirical evidence on the joint dynamics of the dollar and the stock market.²⁵

²⁵In the Internet Appendix to this section, we also present results using bilateral exchange rates instead of the dollar index - results are qualitatively similar. Moreover, we discuss the international role of the pound versus the yen in relation to our theory and as supporting evidence for our mechanism.

5. Debt currency and maturity choice

Our results in Section 4 have direct implications for the link between debt maturity and the incentives to issue dollar-denominated debt. Namely, as the dollar’s co-movement with the stock market increases over longer horizons, we expect that firms would not be indifferent between issuing short-term dollar debt and rolling it over and issuing long-term debt. In particular, we predict that firms would prefer issuing their longer-maturity debt in dollars.

We use data at the bond-issuance level to formally test the hypothesis that the propensity to issue dollar-denominated debt increases with debt maturity. We restrict our attention to banks and non-banks separately and have a sample period between 1999 (the introduction of the euro) and the end of 2019. The dataset includes perpetual bonds as well. To have them in the analysis, we winsorize the maturity of the bonds at 5%, both at the lower and upper tail of their maturity distribution. Winsorizing the maturity at 10% or 2.5% or winsorizing only the right tail of the distribution does not change the results materially. We exclude data on the government sector and focus only on private-sector bond issuance.

We use data from Dealogic in which observations are at the ISIN level of bond issuance. To keep the timing of our analysis similar to the previous sections, we restrict the sample to bonds issued between January 1999 and December 2019. Our dataset includes a total of 706,924 bonds, issued by 61,910 firms that are headquartered in 121 different countries.

The dataset includes information on the identity of the firm, the country where it is headquartered, and the industry, as well as information on the bonds, such as the currency denomination, date of issuance, maturity date, issued amount denominated in the local currency of the firm’s headquarters, and whether the bond is investment grade or is not. In the full sample, the mean of the winsorized maturity is 3,408 days, with a standard deviation of 3,485 days; the minimum value is 365 days, and the maximum value is 11,681 days.

The dollar co-movement with the stock market increases over longer horizons as documented in Section 4. An implication of this result through the lens of our model is that the propensity to issue dollar-denominated debt should increase with debt maturity. Following our results in Section 4,

we test the hypothesis that longer debt maturity is associated with a higher propensity to issue dollar-denominated debt using micro-level data on bond issuance.

To measure the propensity to issue dollar-denominated debt, we use $\mathbb{1}(USD)$, which is a dummy variable that takes the value of 1 if the currency denomination of the bond is the dollar. Then, the independent variables of interest in our regressions become $Maturity_w$, which is the winsorized and standardized value of maturity at the 5% level. According to our hypothesis, we expect a positive coefficient for this variable.

Other control variables are the size of the issuance and a dummy variable that is equal to 1 if the bond is investment grade. Moreover, depending on the specification, we include $Industry * Month$, $Country * Month$, and $firm * Month$ fixed effects. We cluster the standard errors at the $Country * Year$ level.²⁶

We run different linear regressions, varying the fixed effects used, and making different cuts of the sample to test the predictions of our theory. Table 4 presents the results.

The first two columns control for bond characteristics as well as $Industry * Month$ and $Country * Month$ fixed effects for non-banks (in the first column) and for banks (in the second column). The coefficient on $Maturity_w$ suggests a one-standard-deviation increase in maturity increases the likelihood of the currency denomination of the bond to be dollars by 1.5 percentage points for non-banks and 3 percentage points for banks.

Next, as part of our identification strategy, we rely on firms that issue multiple bonds in at least two different currencies in a given month. This choice allows us to tightly identify that the same firm that has access to multiple markets chooses to issue the longer-maturity bond in dollars as opposed to issuing in other currencies. In columns (4) and (5), we run a similar regression for non-banks and banks, respectively, with $Firm * Month$ fixed effects. Although the result for non-banks is of a similar magnitude for non-banks, it is statistically insignificant. On the other hand, the result goes through for banks.

Finally, in columns (5) and (6), we further restrict the sample to firms that are from the US, the eurozone, Japan, Switzerland, or the UK and repeat the exercise in (3) and (4). This aims to address

²⁶In the benchmark specification, we use the country where the parent company of the issuer is headquartered. As a robustness check, we use the residence of the issuer instead. Our results then are virtually unchanged.

Table 4.

Debt-maturity and debt-currency choice

Standard errors clustered by *Country * Year* in parantheses. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively. $\mathbb{1}(USD)$ is a dummy variable that takes the value of 1 if the currency of the issued bond is the dollar. $Maturity_w$ is the standardized value of maturity winsorized at 5% and 95% levels. Controls include the size of the issuance and a dummy variable for whether the bond is investment grade. *NB* refers to the sample of non-bank financials and non-financial corporations. *B* refers to the sample of banks. Columns (3), (4), (5), and (6) only include firms that issue in at least two currencies in a given month. [†] means that the sample is further restricted only to those firms that are from the US, the eurozone, Japan, Switzerland or the UK.

	(1)	(2)	(3)	(4)	(5)	(6)
Sample:	NB	B	NB	B	NB [†]	B [†]
	$\mathbb{1}(USD)$	$\mathbb{1}(USD)$	$\mathbb{1}(USD)$	$\mathbb{1}(USD)$	$\mathbb{1}(USD)$	$\mathbb{1}(USD)$
$Maturity_w$	0.0149***	0.0299***	0.0163	0.0770***	0.0350**	0.0734***
	(0.00339)	(0.00787)	(0.0138)	(0.0126)	(0.0157)	(0.0155)
Controls	X	X	X	X	X	X
Industry*Month FE	X	X				
Country*Month FE	X	X				
Firm*Month FE			X	X	X	X
Observations	457,266	243,657	46,562	67,213	31,857	49,268
R-squared	0.684	0.665	0.450	0.432	0.475	0.472
Mean of Dep. Var	0.556	0.534	0.376	0.348	0.430	0.350

a potential concern that our results in (3) and (4) are driven by the fact that firms in emerging markets could only access dollar-bond-issuance markets. Focusing only on the five countries with liquid and deep capital markets alleviates this concern, because these firms could potentially issue in their home currency or any other major currency. The results from these regressions are in line with our hypotheses both for banks and non-banks.

6. Dynamic capital structure choice

Our main theoretical result in Theorem 2.1 is based on the assumption that capital-structure choice is static. That is, when a firm issues debt at time $t = 0$, it does not reoptimize until the debt expires. In reality, a firm could dynamically readjust its capital structure by frequently buying back old debt or issuing new debt. In this case, a key concern could be that the maturity of originally issued debt may not be the relevant horizon at which to evaluate the correlation of cash flows and debt value. This concern would be all the more important due to the difference in the sign of the covariance between the dollar and the stock market at short versus long horizons.²⁷

In this section, we investigate the consequences of allowing firms to adjust their capital structure dynamically. Accounting for this case is a theoretical challenge due to complexities that arise from non-linear feedback effects from policy functions (i.e., leverage choice) in the future into capital-structure choice in the current period. To the best of our knowledge, we present the first theoretical characterization of dynamic capital-structure decisions with the currency composition of debt. We derive sufficient conditions that lead to the dollar’s dominance in a dynamic setup and provide further empirical evidence in line with the theory.

6.1. Theory

We extend our baseline model by introducing an intermediate period at which firms can rebalance their debt by either issuing new debt or buying back old debt at its market value. Essentially, we consider a three-period model with $t = 0, 1, 2$, where the firm issues debt at $t = 0$ that matures at $t = 2$. The firm generates after-tax profits Y_t at $t = 1, 2$. At $t = 1$, the firm can reoptimize its leverage decisions by calling back debt or issuing more debt.

To characterize the optimal dynamic leverage policy, we need several technical conditions. In what follows, we make the following assumptions:

²⁷Although these concerns are valid, note that as Korteweg, Schwert, and Strebulaev (2018) show, the average firm rebalances its capital structure once every five quarters. According to the results in Section 4, the safe-haven properties of the dollar do not last for five quarters, partially alleviating these concerns. Moreover, Korteweg, Schwert, and Strebulaev (2018) show about 50% of firms issue long-term debt and rebalance their capital structure infrequently, whereas 17% of firms never adjust leverage. These facts suggest the static capital-structure-choice assumption is roughly consistent with many firms’ decisions in the data.

Assumption 3 *We have*

- $\tau - q(j)$ is small for all j .
- cash flows Y_1 are small relative to Y_2 .
- $Y_2 = \Omega_2 Z_1 Z_2$, where idiosyncratic shocks Z_t are i.i.d. with the density $\ell Z^{\ell-1}$ on $[0, 1]$, and are independent of aggregate shocks.
- For any aggregate shock realization at time $t = 1$, the best firm (i.e., the firm with $Z_1 = 1$) does not default (i.e., some firms survive even the worst crises).
- The “marginal” firm with a Z_1 realization that is indifferent between defaulting and not defaulting at $t = 1$ does not issue new debt at time $t = 1$.²⁸

Our first result is the following:

Proposition 6.1 (The leverage ratchet effect) *Suppose either Assumption 3 holds or currency volatilities are sufficiently small. Then, even if the firm has issued long-term debt (maturing at time $t = 2$) in multiple currencies at time $t = 0$, buying back any of this debt at time $t = 1$ is never optimal. At the same time, issuing more debt at time $t = 1$ might be optimal.*

This proposition is an extension of the classic leverage ratchet effect of [Admati et al. \(2018\)](#) to the case of debt issued in multiple currencies. The intuition is the same as in [Admati et al. \(2018\)](#): buying back debt makes shareholders forego all the tax benefits for which the debt has been issued in the first place, making it suboptimal to reduce leverage. Thus, the optimal amount of debt is monotonically increasing (or stays constant) over time. With dynamic debt issuance, a novel effect that may occur is that buying back debt makes issuing new debt cheaper. Thus, one may ask if a substitution effect may occur: a firm buys back debt in one currency and issues debt in another currency. Trivially, the magnitude of the reduction in issuance costs is proportional to the optimal new-debt-issuance amount. The first item of our technical Assumption 3 above guarantees that taking high leverage is never optimal for the firm, and as a result, “debt reshuffling” is never

²⁸The last two conditions are natural and can be formulated as parametric restrictions on the underlying aggregate shocks. See the Internet Appendix.

optimal. Similarly, if currency volatilities are small, the gain from reshuffling the risk profile is too small to justify the loss of tax benefits.

We will denote by $r_t(j) = -\log E[M_t \mathcal{E}_{j,t}]$ the country- j nominal interest rate for horizon t . The following theorem derives conditions for the optimality of issuing dollar debt both at $t = 0$ and $t = 1$:

Theorem 6.2 *Issuing only dollar debt both at time $t = 0$ and $t = 1$ is optimal if and only if the following two conditions holds:*

- $\text{Cov}_1(\Omega_2^{-\ell}, \mathcal{E}_{j,2}) \geq 0$ for all j .
- We have

$$\frac{q(\$) - q(j)}{\tau - q(\$)} \leq \frac{\text{Cov}^{\$}(\Omega_2^{-\ell}, \mathcal{E}_{j,2})}{E^{\$}[\Omega_2^{-\ell}]E^{\$}[\mathcal{E}_{j,2}]} + \frac{E^{\$}[\Omega_2^{-\ell} \mathcal{E}_{j,2}]}{E^{\$}[\Omega_2^{-\ell}]E^{\$}[\mathcal{E}_{j,2}]} \frac{c_1(e^{r_2(\$)-r_1(\$)} - e^{r_2(j)-r_1(j)})}{c_1 e^{r_2(j)-r_1(j)} + c_2}$$

In particular, if $q(\$) = q(j)$ for all j , then a sufficient condition for issuing only dollar-denominated debt is that

- (a) the dollar is the riskiest currency so that $\text{Cov}_t^{\$}(\Omega_2^{-\ell}, \mathcal{E}_{j,2}) \geq 0$ for all j and $t = 0, 1$, and
- (b) the dollar has the largest term premium: $r_2(\$) - r_1(\$) > r_2(j) - r_1(j)$.

The intuition behind Theorem 6.2 is as follows. Firms issue debt due to the tax benefits of doing so, and optimal capital structure is determined by the trade-off between the tax benefits and the risk of default. At the time $t = 1$, debt is issued to be held until it expires. Hence, Theorem 2.1 applies and the inequality $\text{Cov}_1^{\$}(\Omega_2^{-\ell}, \mathcal{E}_{j,2}) \geq 0$ is necessary and sufficient for the optimality of dollar debt. The situation at $t = 0$ is more complex. From the time $t = 0$ point of view, both the tax benefits and the effective costs of default (due to the lost cash flows) accrue at times $t = 1$ and $t = 2$ when the coupon is paid. Because by assumption, most of the cash flows occur at time $t = 2$, highest costs of default also occur at this time. Thus, the trade-off can be decomposed as:

$$\text{trade-off} \approx \text{tax benefits}(t=1) + \text{tax benefits}(t=2) - \text{default cost}(t=2).$$

The default cost itself can be decomposed further into

$$\text{default cost}(t = 2) = \text{average cost}(t = 2) + \text{cost from co-movement with } FX(t = 2).$$

As in Theorem 2.1, the trade-off between *tax benefits*($t = 2$) and the *cost from co-movement with FX*($t = 2$) is determined by $\text{Cov}^{\$}(\Omega_2^{-\ell}, \mathcal{E}_{j,2})$. Thus, we are left with the second, purely inter-temporal part of the trade-off:

$$\text{intertemporal trade-off} = \text{tax benefits}(t = 1) - \text{average cost}(t = 2).$$

Naturally, this trade-off is determined by the slope of the yield curve: the tax benefits at time $t = 1$ are discounted at the rate $r_1(j)$, whereas the default cost paid at time $t = 2$ is discounted at the rate $r_2(j)$. The larger the difference $r_2(j) - r_1(j)$, the stronger the incentive to issue debt in currency j , get the tax benefits at $t = 1$, and pay the cost at time $t = 2$.

6.2. Empirical evidence

In this section, we provide empirical evidence showing the yield-curve slope differential between the dollar and the euro is a relevant variable for the choice of currency in debt issuance.²⁹ We view this evidence as additional support of the “debt view”: the fact that dollar-debt issuance is (at least partially) driven by firms’ optimal capital-structure choices.

Similarly to Propositions 3.1 and 3.2, Theorem 6.2 implies a positive relationship between the yield-curve slope differential, $(r_2(\$) - r_1(\$)) - (r_2(j) - r_1(j))$ and dollar-debt issuance. Fig. 6 illustrates that the 5y-6m difference between the US Treasury and the German bund curve has largely been positive and increasing since 2008, whereas it was negative and at times decreasing before 2008. This finding is in line with the decline of the share of dollar debt before 2008 and the subsequent rise of this share after 2008 (see Fig. 4).³⁰ Moreover, we show in a regression that

²⁹Note that, in theory, we have $r_t(j) = -\log E[M_t \mathcal{E}_{j,t}]$ the country- j nominal interest rate for horizon t . $r_t(j)$ are the non-annualized interest rates. Therefore, we scale back the yields that we obtain from the yield curves to reflect the non-annualized interest rates.

³⁰Although we illustrate this only for 5y-6m, it is qualitatively similar for other horizons, such as 1y-6m, 2y-6m, 10y-6m, 2y-1y, 5y-1y, and 10y-1y.

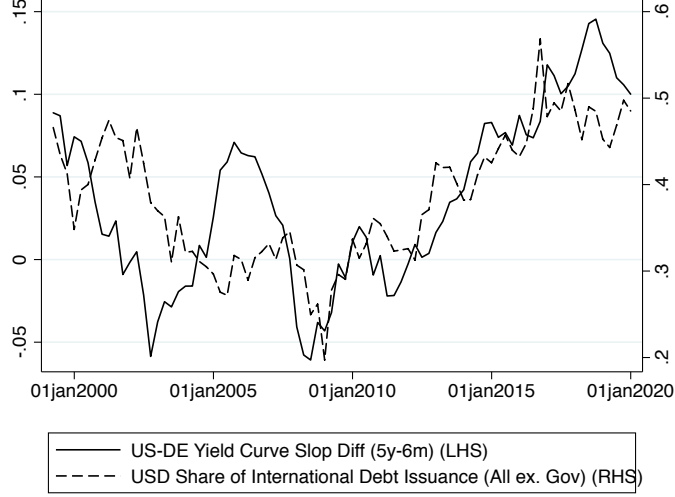


Fig. 6. Yield curve slope differentials and dollar debt share

these differences are positively associated with the share of dollar debt for various horizons. In Table 5, we show the results of a simple regression of the share of dollar-debt issuance at a given time t on the difference between the slopes of the yield curves between the US and Germany. Our independent variable, denoted as $Diff_{r_2, r_1, t}^{US, DE}$, equals $(r_2(US) - r_1(US)) - (r_2(DE) - r_1(DE))$ in the notation of Theorem 6.2. As one can see, consistent with Theorem 6.2, the relationship is positive and highly significant for all horizon combinations.

7. The debt view during the COVID-19 crisis and its aftermath

The COVID-19 crisis in March 2020 and its aftermath also provide a useful test for our theory. According to our theory, firms borrow in dollars as opposed to other major currencies, due to the expectation that the dollar would depreciate following a bad global shock relative to other currencies (see Section 4.2. and Fig. 5). Furthermore, the rising share of the dollar-debt issuance in the post-GFC periods suggests a strengthening of this expectation from our theory's point of view.

The left-hand side of Fig. 7 shows the evolution of the dollar exchange rate against the euro,

Table 5.

US-Germany yield-curve slope differential and the share of dollar debt

Robust standard errors are in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively. Debt-issuance data includes all sectors except the government. $Diff_{r_2,r_1,t}^{US,DE}$ measures the difference between the US and Germany of the difference between the non-annualized interest rate over r_2 months and the non-annualized interest rate over r_1 months: $(r_2(US) - r_1(US)) - (r_2(DE) - r_1(DE))$. The sample period is 1999Q1-2019Q4. Each column shows the coefficient on $Diff_{r_2,r_1,t}^{US,DE}$ of the regression of USD_t^{shr} on $Diff_{r_2,r_1,t}^{US,DE}$, for different values of r_1, r_2 , and controls. Controls include a time trend and total international debt issuance excluding issuance by governments in a given quarter.

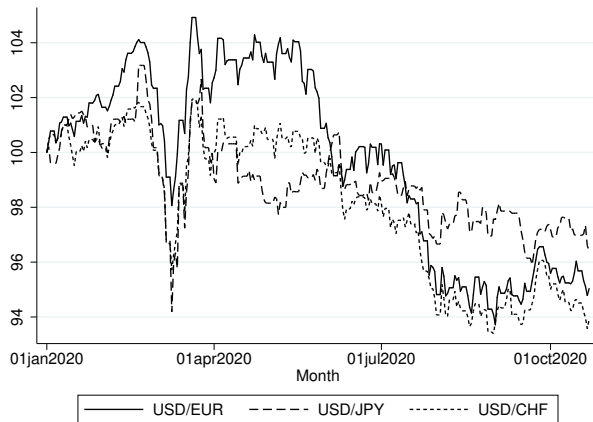
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Dep. Var:	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}	USD_t^{shr}
Indep. Var:	$Diff_{12,6,t}^{US,DE}$	$Diff_{24,6,t}^{US,DE}$	$Diff_{60,6,t}^{US,DE}$	$Diff_{120,6,t}^{US,DE}$	$Diff_{24,12,t}^{US,DE}$	$Diff_{60,12,t}^{US,DE}$	$Diff_{120,12,t}^{US,DE}$
	2.539***	1.016***	0.515***	0.279***	1.633***	0.612***	0.303***
	(0.873)	(0.297)	(0.119)	(0.0637)	(0.447)	(0.134)	(0.0673)
Controls	X	X	X	X	X	X	X
Observations	84	84	84	84	84	84	84
R-squared	0.618	0.629	0.656	0.664	0.635	0.661	0.666

Japanese yen, and the Swiss franc. Unlike previous episodes of global shocks, the dollar depreciated against these currencies without a meaningful initial appreciation. Moreover, this depreciation has been material to the order of around 10% against the euro. This finding highlights that the dollar's depreciation provided a hedge for firms during the COVID-19 downturn, with dollar debt providing support for our theory.

The channel that runs in our theory to explain the dollar's dominance emphasizes the role played by the response of the monetary policy to shocks. During the COVID-19 crisis, the Federal Reserve reacted swiftly and forcefully to respond to the shock by reactivating a number of crisis-response tools used in the GFC as well as introducing new ones, all contributing to the decline of the dollar against major currencies, reinforcing investors' expectations about the ability of the US monetary policy of alleviating the debt burden of firms in bad times.

Our paper's findings might also shed light on the future of the dollar's dominance in denomi-

The dollar against major currencies



Inflation risk premia

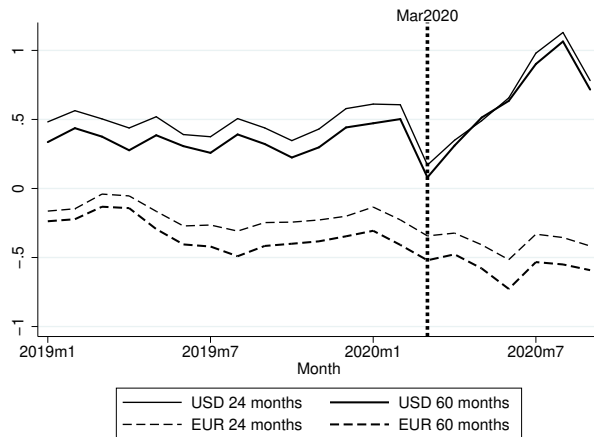


Fig. 7. The dollar and inflation risk premia during the COVID-19 crisis. Sources: Datastream, [Hördahl and Tristani \(2014\)](#), authors' calculations.

nating debt. Our theory suggests the continuing divergence between the dollar and euro inflation risk premia during the COVID-19 crisis (see the right-hand panel of Fig. 7) will further strengthen the dollar's international role in denominating debt contracts, consistent with Proposition 3.2.

We provide preliminary evidence that firms are more likely to issue dollar debt after the COVID-19 crisis using granular bond-issuance data. We control for several factors to account for whether the same firms' propensity to issue dollar debt is higher after the COVID-19 crisis compared with other major currencies. We restrict the sample to bond issuance in five currencies: the dollar, the euro, the yen, the Swiss franc, and the pound, only in 2019 and 2020 (data retrieved from Dealogic in October 2020). We also divide the sample into pre- and post-COVID from April 1, 2020, which leaves us with 5,099 observations for banks, 4,268 of which are pre-COVID and 831 are post-COVID; 25,042 observations for non-bank financials, 18,786 of which are pre-COVID and 6,256 of which are post-COVID; and 6,640 observations for non-financial corporations, 4,136 of which are pre-COVID and 2,508 of which are post-COVID.

We run a regression of whether the bond is issued in dollars or other four currencies ($\mathbb{1}(USD)$), on a dummy, $\mathbb{1}(Post_COVID)$, which indicates whether the issue date is after April 1, 2020 as

well as other control variables, such as the size of issuance, maturity, whether it is investment grade or not, and finally firm fixed effects. We present the results in Table 6. The three columns show the results for banks, non-bank financials, and non-financial corporations, respectively. The fourth column only focuses on the dollar and euro issuance by firms outside the US and the euro area for the full sample of banks, non-bank financials, and non-financial corporations.³¹ All columns suggest that all else being constant, firms have tended to issue more dollar debt than other-major-currency debt since April 2020.

Table 6.

Debt-issuance and debt-currency choice: Pre- and post-COVID period

Robust standard errors are in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively. The sample in columns (1), (2), and (3) is restricted to issuance in five currencies, USD, EUR, JPY, CHF, and GBP, in 2019 and 2020 (data retrieved in October 2020 from Dealogic). $\mathbb{1}(USD)$ is a dummy variable that takes the value of 1 if the currency of the issued bond is the dollar. $\mathbb{1}(Post_COVID)$ is a dummy that is 1 if the issue date is after April 1, 2020. Controls include the winsorized maturity at 5%, the size of the issuance, and a dummy variable for the investment-grade status of the bond. All columns include a firm fixed effect. *B* refers to the sample of banks, *NBFI* refers to the sample of non-bank financials, and *NFC* refers to the sample of non-financial corporations. Column (4) includes all these sectors. The [†] in column (4) means observations are limited to dollar and euro issuance by firms outside the US and the euro area.

	(1)	(2)	(3)	(4)
Sample:	B	NBFI	NFC	Full [†]
	$\mathbb{1}(USD)$	$\mathbb{1}(USD)$	$\mathbb{1}(USD)$	$\mathbb{1}(USD)$
$\mathbb{1}(Post_COVID)$	0.0269**	0.00772**	0.0250***	0.0325***
	(0.0122)	(0.00375)	(0.00841)	(0.0121)
Controls	X	X	X	X
Firm FE	X	X	X	X
Observations	4,978	24,506	5,866	6,472
R-squared	0.751	0.924	0.875	0.666

³¹Dividing the fourth column into different samples of the three sectors yields qualitatively similar results, but not statistically significant for non-bank financials and non-financial corporations due to large standard errors in part because of relatively small sample sizes.

8. Conclusion and policy implications

Motivated by two facts, namely, the dollar’s dominant international role in debt markets and the fall and the subsequent rise of the dollar in these markets over the last two decades, we address two questions. First, of all the major international currencies, why is the dollar the dominant currency? Second, what explains the fall and rise of the dollar?

We propose a “debt view” to explain the dollar’s dominant international role and provide broad empirical support for it. We develop a simple capital-structure model in which firms optimally choose the currency composition of their debt. Independent of the lenders’ stochastic discount factor, borrowers behave as if they have a “CAPM discount factor,” whereby the debt-currency choice of borrowers depends on how each currency co-moves with the firm’s stock value. In this sense, borrowers prefer debt issuance in the riskiest of international currencies. Both forward-looking and historical covariances suggest the dollar fits this description better than all major currencies, especially for longer horizons. Moreover, the debt view can jointly explain the fall and the rise of the dollar in debt markets during the pre- and post-2008 and offer insights into the future of the dollar’s international role in the aftermath of the COVID-19 crisis.

The debt view is borrower driven, in contrast to the conventional view, which is investor driven. The debt view can account for why firms issue in dollars despite the dollar not being the “safest” currency. It can also account for why the dollar has higher nominal interest rates and why the dollar’s international role was cemented following its depreciation against major currencies in the 1970s after Bretton Woods. Moreover, once firms prefer to issue dollar debt, partially explaining the dollar’s role in the rest of the international monetary and financial system might be possible, for example, why firms with dollar debt would prefer to invoice trade in dollars, or why a central bank would accumulate dollar reserves, among others. However, we leave this broader analysis of the dollar’s international role to future work.

Our results have some policy implications. First, a common belief is that an exchange-rate depreciation could help an economy in downturns, mainly through its effect on the terms of trade. Our results imply exchange-rate depreciation could also help an economy by reducing the probability

of default of indebted firms. Second, our results imply that if a country wishes to gain a dominant currency status for debt issuance, that country's currency cannot be the "safest haven" currency and should be riskier than its counterparts. Moreover, an essential role for the central bank arises, which is not to have realized inflation undershoot inflation expectations in downturns, generating appreciation pressures for the currency. To that end, if the European Union wishes to enhance the role of the euro as a dominant international currency, the debt view would suggest this scenario could be possible if inflation were more countercyclical.

What do our results imply for the future of the dollar? Many explanations of the dollar's dominant role in the international monetary system feature arguments such as inertia, size, network externalities, and market liquidity. All these arguments suggest changes in the dominance status of a currency occur slowly. By contrast, our results indicate the dollar can lose its dominance if the expectations about the risk properties of the dollar and other currencies change. Because this dominance relies on the beliefs of market participants, changes might occur abruptly. Our evidence from quarterly regressions suggests this channel is relevant.

This paper fits into a broader research agenda that aims to study the use of various currencies in different parts of the economy through the lens of their risk properties. Our model can be extended in multiple directions. First, addressing the interactions between the dollar's role in trade, banking, and finance may shed important light on how debt issued in a dominant currency could affect other parts of the economy through the lens of the debt view. Second, modeling the demand for safe assets would help us understand the role of the dollar for financial intermediation and household balance sheets and firms issuing debt jointly. We leave these questions for future research.

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