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Hedging and choice of currency denomination in international syndicated loan markets ☆

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Abstract

We examine the determinants of the currency denomination of debt decision of Australian and New Zealand firms and compare it with that of Asian firms around the 1997 Asian crisis. We control for location choice, and include firm and country specific determinants. We find hedging is the primary determinant of foreign currency borrowing by Australian and New Zealand firms. In Asian firms, however, firm leverage, the exchange rate regime, country political risk, and interest rate differentials determine the currency denomination of debt. With the exception of Hong Kong based firms, there is *no* support for the hedging hypothesis in Asian firms.

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1. Introduction

The literature examining the structure of debt contract terms has generally focused on how asymmetric information, agency costs, taxes and credit quality affect the pricing, maturity and secured status of debt contracts (e.g., Chan and Thakor, 1987; Diamond, 1991; Diamond, 1993; Guedes and Opler, 1996; Dennis et al. 2000). Firms borrowing in international debt markets need to determine a fourth contract term, namely the currency in which the debt is denominated. This paper extends the analysis of debt structure by examining the determinants of currency choice in international lending.

Currency choice may be influenced by a range of company and country specific factors. At the company level, foreign currency denominated debt (FCDD) may be used to hedge exchange rate risk, to access cheaper funding, or to alleviate agency costs. At the national level, companies may issue FCDD to access more liquid debt markets, to overcome high transaction costs associated with exchange controls, and to overcome political risk. Conversely, firms domiciled in countries with fixed exchange rate regimes may perceive little need to hedge exchange rate risk and therefore to issue FCDD for hedging purposes.[1]

The existing empirical literature on the choice of currency denomination of debt is limited to two studies. Keloharju and Niskanen (2001) examine the currency choice decision using survey data for 337 public and private debt issues made by Finnish firms from 1985 to 1991 into domestic and foreign markets. Their results suggest the choice between domestic and foreign currency denominated debt is affected by hedging, firm size, and speculation. Kedia and Mozumdar (2003) examine the determinants of currency choice for a sample of large US firms in 1996. In order to determine the extent of reliance on FCDD, balance sheet data obtained from Compustat is matched with Moody′s data detailing the currency denomination of debt. A unique aspect of their study is the disaggregation of foreign currency alternatives into individual currencies. In eight of the nine currency pairs examined, foreign operations are a statistically and economically significant determinant of the choice between issuing US dollar denominated debt and foreign currency debt.

There are several limitations of this prior literature. First, because the samples are confined to firms in a single country, it is not possible to examine how the exchange rate regime may influence currency choice. The investigation of the effect of exchange rate regimes on currency choice is especially relevant given that currency arrangements have been blamed for much of the turmoil ensuing in the Asian crisis in 1997.

Secondly, the data used does not allow a separation of the location (i.e. onshore versus offshore borrowing) and currency choice decisions. The distinction between *currency* and *location* choice decisions affects both the sample selection criteria and the choice of explanatory variables. By including debt issued in domestic markets (denominated in domestic currency) together with debt issued in offshore markets (denominated in either domestic or foreign currency), location and currency choice decisions cannot be separated and it is not possible to determine whether the decision to issue domestic currency debt in the local market represents a currency or a location choice decision. Similarly, the issuance of international bonds involves both a location choice and currency choice decision. Furthermore, the determinants of currency choice and location choice need to be carefully distinguished. To illustrate, Kedia and Mozumdar (2003) include tax differentials in their model of currency choice, which they find are not significant. Consistent with

[1] According to Euroweek (1998), the pegged exchange rate regimes of many South-East Asian economies gave investors a false sense of security prior to the Asian crisis.