Currency Diversification in International Financial Markets

High U.S. interest rates, the enduring strength of the dollar, and widespread international debt problems call attention to the currency composition of international credit. On the surface, diversifying the currency denomination of credit would reduce the exposure of both borrowers and lenders to unforeseen sharp movements in rates of exchange or interest. Yet two important sectors of the global credit market—international syndicated credits and international bonds—show completely opposite movements in currency denomination.

In the syndicated credit markets, new dollar lending has fallen sharply since 1981 and the share of total new loans in nondollar currencies has risen strongly. But in the international bond markets, the reverse holds: new issues in dollars have reached record levels and the share of total new issues in nondollar currencies has been well below pre-1981 levels. These contrasting movements of currency shares can be explained by the primary role of borrowers in the syndicated credit markets and lenders in the international bond markets in determining the currency denomination.

Syndicated credits

In the syndicated credit markets, borrowers exert a large influence on the currency denomination of loans and they have many motives for diversifying. Banks, the lenders, can generally hedge their exchange risk and so are often willing to accommodate a borrower's choice of currency. Besides the high cost of dollar borrowing, increased exchange rate volatility has encouraged some borrowers to switch to a mix of currencies or to stay in their domestic currency. Diversification from the dollar has also been spurred by liberalization of financial markets in Japan and the United Kingdom. This increased the opportunities for Euro-lending in these currencies.

Overall, the rise in the nondollar share of syndicated credits largely reflects diversification by industrial country borrowers. The nonoil LDCs have also engaged in more currency diversification since 1981, with the Asian countries showing a greater propensity to diversify than the Latin American countries. In addition, the cutback in new lending to Latin America has reinforced the decline in the dollar share since Latin American borrowing has traditionally been denominated almost exclusively in dollars.

Among the major nondollar currencies, shares of the Japanese yen, pound sterling, and Canadian dollar have risen substantially. Among the other currencies, new markets have developed for the European currency unit, Australian dollar, Hong Kong dollar, and Spanish peseta.

International bonds

In the international bond markets, the preferences of lenders, principally individual private investors, appear to be the main determinant of the currency composition of loans. Borrowers in this market have traditionally included international institutions, governments and their agencies, and corporations. In many cases, these bor-

Table 1

Syndicated Loans by Currency

In percent*

Currency	1979	1980	1981	1982	1983
U.S. Dollar	90.0	89.4	86.9	78.8	74.0
Japanese Yen	3.7	0.5	0.9	2.7	5.5
German Mark	2.6	3.0	1.2	2.4	1.6
Pound Sterling	1.0	1.5	4.3	5.7	5.3
Canadian Dollar	0.2	0.8	1.2	2.4	3.8
Hong Kong Dollar	0.2	1.2	1.1	1.0	1.4
Swiss Franc	0.2	0.6	0.2	0.2	0.4
European Composite Units	—	—	0.1	0.2	1.1
Australian Dollar	—	0.8	0.2	0.8	2.2
Spanish Peseta	—	0.1	0.4	0.4	1.1
Other	2.2	2.1	3.5	5.4	3.5

*Totals may not add due to rounding.
Source: *Euromoney Syndication Guide.*

Table 2

Issues of Foreign Bonds and Eurobonds by Currency

In percent*

Currency	1979	1980	1981	1982	1983
U.S. Dollar	41.7	47.4	64.9	63.9	56.2
Swiss Franc	23.9	18.2	15.6	14.6	18.8
German Mark	22.0	20.1	4.9	7.1	8.5
Japanese Yen	4.8	3.3	5.3	4.9	5.2
Dutch Guilder	1.5	3.1	1.9	2.2	2.3
Canadian Dollar	1.0	0.7	1.2	1.5	1.4
Pound Sterling	0.7	2.7	2.4	2.5	3.6
European Composite Units	0.6	0.2	0.6	2.5	2.7
Other	3.9	4.3	3.2	0.8	1.3

*Totals may not add due to rounding.
Source: Morgan Guaranty Trust, *World Financial Markets*.

rowers have used the sale of an international bond as a means of hedging future receipts in that currency. Investors, on the other hand, generally carry the exchange risk involved in purchasing an international bond. In part, this may happen because long-term hedging opportunities for nonbank investors are limited. Nevertheless, Eurobond investors have shown a willingness to take deliberate positions on the currency composition of their portfolios.

In the last few years, there have been many reasons to buy dollar-denominated assets. Total returns to investors have been boosted by relatively high nominal U.S. interest rates and a generally strengthening dollar from late in 1980. Investors have also been offered protection of total returns to the extent that the fall in bond prices resulting from an upward movement in U.S. interest rates might be associated with a rise in the dollar exchange rate.

Strong demand for dollar assets allowed regular issuers and new borrowers to raise a large volume of funds in the Eurodollar bond market on favorable terms. U.S. companies were prominent in 1981 and 1982, financing a much higher share of their bond borrowings in the Eurodollar bond market than they had in earlier years. A deepening in the secondary market, allowing larger primary issue volumes to be absorbed more easily, further increased the market's attraction.

As the dollar share rose, shares of the German mark and, to a lesser extent, the Swiss franc fell. The sharp decline in the German mark share in 1981 reflected, to some degree, informal actions by the authorities to limit the issuance of foreign bonds. Despite the absence of these actions in later years, the German mark share remained well below the levels achieved in 1979-80.

Although slipping somewhat from its 1982 level, the dollar share stayed relatively high through 1983 and the first part of 1984. Within the Eurodollar market, floating-rate-note issues by banks and governments have increased strongly. Banks have also raised substantial amounts in the fixed-rate market, often to swap the proceeds for floating-rate funds. The greater issuance of medium-term bonds by banks has increased the maturity of their liabilities, and thus has balanced to some extent the lengthened maturity of recently rescheduled loans. (This is discussed more fully in the following article.)

Andrew Mohl