Currencies

Trade, Exchange-Rate Exposure and the Currency Composition of Debt

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Working paper

This paper develops a quantitative structural model of trade and the currency composition of debt for firms in a small open economy with exchange rate risk. Monopolistic competition in the product market generates exchange rate exposure for all firms, both exporting and local.

Due to financial frictions, firms optimally issue foreign debt as a hedge against this exposure. The model is estimated using a firm-level dataset of traded Mexican firms. The estimated model fits the data well and is able to rationalize the observed magnitude of foreign debt issued by both local and exporting firms in Mexico.

Counterfactual experiments are used to quantify the consequences of cheap foreign debt and high costs of equity issuance on debt and default policies of firms.

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