

International Pecking Order*

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Abstract

We document that firms in emerging markets borrow more in foreign currency when the local currency actually provides a better hedge in downturns. Motivated by this fact, we develop an international corporate finance model in which firms facing adverse selection choose the foreign currency share of their debt. In the unique separating equilibrium, good firms optimally expose themselves to currency risk to signal their type. Crucially, the nature of this equilibrium depends on the co-movement between cash flows and the exchange rate. We provide extensive empirical evidence for this signalling channel using a rich micro dataset including more than 4,800 firms in 19 emerging markets between 2005 and 2021.

Keywords: Foreign currency debt, corporate debt, signalling, exchange rates, pecking order

JEL Classification Numbers: D82, F34, G01, G15, G32

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1 Introduction

Many emerging market firms finance themselves with foreign currency denominated debt. Yet foreign currencies, especially safe haven currencies, appreciate against the local currency during downturns. Many firms that borrow in foreign currency are neither exporters nor do they employ currency hedges (e.g. [Bräuning and Ivashina, 2020](#); [Alfaro, Calani and Varela, 2022](#)). The resulting currency mismatches amplify the impact of exchange rate shocks on firms, especially those that are in distress. This has been a recurring theme in emerging market crises. Corporate leverage and foreign currency borrowing, especially in dollars, have increased in recent years ([Alfaro, Asis, Chari and Panizza, 2019](#); [Maggiore, Neiman and Schreger, 2020](#); [Eren and Malamud, 2022](#)), making the reasons for borrowing in foreign currency and associated risks all the more important to understand.

Despite risks, foreign currency debt is also a potentially important source of funds for firms to grow, especially for those that are more productive ([Salomao and Varela, 2022](#)). While the literature on how foreign currency debt contributes to financial crises is large, analyzing micro-level trade-offs that firms face and the resulting cross-sectional allocations provides a promising new avenue for research. Our paper makes a theoretical and empirical contribution to this nascent literature.

We first document that, among emerging market economies we study, corporates for which borrowing in local currency would provide greater hedging benefits actually borrow more in foreign currency. In particular, we show that in countries for which the co-movement of the returns on the local currency sovereign bond and the stock market is greater (i.e. local currency provides a better hedge against downturns),¹ the average foreign currency share of the emerging market corporates is larger. This observation is puzzling as it suggests that firms, for which foreign currency borrowing is riskier, borrow even more in foreign currency.

This puzzling fact mimicks the borrowing pattern of sovereigns documented in [Du, Pflueger and Schreger \(2020\)](#). In the case of sovereigns, they explain this by the presence of risk-averse international lenders and the lack of monetary policy commitment of the sovereign. However, the

¹Given data limitations, constructing measures of local currency corporate bond return is difficult. Nevertheless, the literature has found considerable co-movement between sovereign yields and corporate yields (e.g. [Mendoza and Yue, 2012](#); [Bedendo and Colla, 2015](#); [Bevilaqua, Hale and Tallman, 2020](#)).

fact that corporates in emerging markets do not have power over monetary policy necessitates a different explanation of our findings.

We develop an international corporate finance model in which firms facing adverse selection choose the composition of their debt in local currency and foreign currency. Our model is set up as a one-dimensional signalling game. A firm with private information about its future cash flows needs to finance investment with debt that can be denominated in two currencies, local currency and foreign currency. The only choice variable of the firm is the fraction of foreign currency debt. Risk-neutral, rational creditors offer price schedules conditional on firms' choice of foreign currency debt share.

We show that, under natural conditions, there exists a unique separating equilibrium, featuring a monotonic relationship between the foreign currency share and the hidden firm quality. The fraction of foreign currency debt perfectly reveals the firm's hidden ability to generate earnings. In this equilibrium, good firms expose themselves to currency risk to signal their type to investors. The intuition behind this result is similar to that in the standard pecking order theory: A default due to an adverse foreign currency appreciation shock is less likely for good firms. By voluntarily taking on currency risk, lenders understand these firms have higher repayment probabilities and price the debt accordingly. The benefit in revealing the hidden type thus outweighs the need to hedge against adverse exchange rate movement through reducing currency mismatches.

Our model therefore also provides a rationale for why emerging market firms do not generally hedge currency exposures. Anecdotally, [Ivashina, Kostas and Zogbi \(2018\)](#) report a statement by Advent LatAm managers, a global private equity firm: "We [Advent] have never hedged; it is too expensive. The only hedge we have is growth." The statement fits well with the mechanism in our model, where firms expose themselves to currency risk to signal their quality or growth potential to investors.

A key insight of the model that is an important factor distinguishing our paper from others is that the nature of this equilibrium depends crucially on the co-movement between the foreign currency/local currency exchange rate and firm's cash flows: If the foreign currency exchange rate is negatively related to firm's cash flows, that is cash flows fall when the local currency depreciates,

then higher foreign currency debt signals a good type, *and vice versa*. While the former is the case for many emerging market economy firms, this dichotomy is a distinctive prediction of our theory which we test empirically.

We find strong empirical support for the predictions of our model that links exchange rate-cash flow co-movements, foreign currency share in borrowing, and performance. Using a detailed dataset on the debt structure of firms in 19 emerging market economies, we show that both levels and changes in the foreign currency debt share predict firm performance, leveraging the rich panel structure of the dataset as well as using large local currency depreciation episodes as event studies. Importantly, we also find evidence for the key distinctive prediction of the theory, namely a dichotomy between firms with positive and negative co-movement between cash flows and exchange rate.

For our empirical analysis, we construct a comprehensive firm-level dataset using Capital IQ, S&P Global Market Intelligence. This database includes detailed information at the individual debt instrument level that a firm has on its balance sheet, which includes bank loans and bonds. We aggregate this data to generate our main variable of interest, the foreign currency share, and match it to balance sheet data, income statements and firms' stock returns. This exercise gives us a firm-level yearly panel dataset for more than 4,800 firms in 19 emerging market economies between 2005 and 2021.

We first focus on firms for which cash flows co-move negatively with the dollar (i.e. “negative beta” firms). This is the case for a large majority of firms in our sample and this is the case which matters during local currency depreciation periods, since the appreciation of safe haven currencies would in principle adversely affect these firms.

Leveraging the panel structure, we use a battery of fixed effects and firm-time level information to single out both the level and the changes of foreign currency share of debt as predictor of future performance. We rule out several alternative explanations through a number of robustness checks. We also control for other potential signalling channels isolating the effect of foreign currency borrowing as a signalling channel. Through event studies, we show that among negative beta firms,

those that had a greater foreign currency debt share performed better during large local currency depreciation episodes; a counter-intuitive result which can be explained through our model.

Crucially, in line with the key prediction of the signalling channel, we show that there is a dichotomy between positive and negative beta firms since these firms expose themselves to currency risk differently. Negative beta firms with greater earning capabilities signal by borrowing more in foreign currency, while positive beta firms with greater earning capabilities signal by borrowing more in local currency, whereby they expose themselves to currency risk. In the data, indeed, higher foreign currency share predicts worse performance for positive beta firms, in stark contrast to negative beta firms.

In the presence of information asymmetries, currency mismatches help firms reveal their types to investors, but such signals are costly as it is generally the case in models of signalling ([Spence, 1973](#)). In the model, this leads to firm-level credit UIP deviations. Using the available information on the prices of firms' debt within our dataset, we also provide evidence for such deviations that is in line with the predictions of our model.

All in all, our results point toward a new channel of why firms expose themselves to currency risk. In the presence of adverse selection, firms have incentives to signal their quality to their creditors by taking on exchange rate risks arising from currency mismatches. Our results therefore highlight a more nuanced view on the risks arising from foreign currency borrowing. Firms that take on exchange rate risks might indeed be better placed to have these risks on their balance sheets. However, since they are exposed to currency risk, large exchange rate shocks might nevertheless put them in distress. Our results also suggest that policies that aim at reducing information asymmetries and adverse selection, such as more transparency or better disclosure requirements would mitigate corporate risk taking through currency mismatches in emerging market economies.

Related literature Our paper mainly contributes to two strands of literature, both theoretically and empirically. First, there is a nascent literature on the cross-sectional heterogeneity in firms' choices leading to currency mismatches, which can have implications in the aggregate ([Salomao and Varela, 2022](#)). We explore a signalling channel in the face of adverse selection and provide broad evidence for many emerging market economies through a number of event studies. In doing so, we

also contribute to strands of literature that analyze firm borrowing in foreign currencies and risks arising from resulting currency mismatches. Second, we contribute to the literature on the pecking order theory (Myers and Majluf, 1984), by considering two types of debt in an international setting and providing an empirical investigation of the channels outlined.

The closest papers to ours are by Salomao and Varela (2022), Du, Pflueger and Schreger (2020), and Eren and Malamud (2022). We describe how our paper differs from these papers and how it complements them in detail below.

Salomao and Varela (2022) build a model with heterogeneous firms to analyze the trade-offs in firms' currency debt decisions and assessing the distribution of foreign loans and its aggregate consequences. Though some mechanisms in their paper are similar to ours, there are three major differences between our approaches. First, without assuming cost advantages associated with currency borrowing, the key mechanism that affects currency mismatches in our model is signalling.² In their paper, firms have an incentive to borrow in foreign currency to exploit UIP differentials. Second, in their model currency risk affects firm profitability as noise that doesn't co-move with firms' cash flows, whereas in our setup firms whose cash flows negatively correlate with the dollar take on the additional risk to signal to investors, and vice versa. Third, our empirical analysis covers firms in a number of emerging market economies while their paper focuses only on a single country (Hungary). We believe our analysis complements theirs as we propose an additional channel for why firms take on currency mismatches.

Du, Pflueger and Schreger (2020) show that governments tend to borrow in currencies that tend to appreciate in bad times rather than borrowing in local currency which provides a hedge. They argue that governments resort to foreign currency borrowing to alleviate the moral hazard problem of deflating their local currency debt through inflation. While the mechanisms that drive their results, such as lack of commitment in setting monetary policy, apply to sovereigns, they do not

²Phan (2017) develops a theoretical model of sovereign debt as a signaling device. In his model, the realization of productivity shocks can be only observed by the sovereign while the foreign investors can only observe its distribution. Similar papers include Cole, Dow and English (1995) and Sandleris (2008). In our model of currency choice, the lenders make decision only based on the foreign-currency share of issuance. We also provide empirical support for the signaling channel of currency choice.

apply to corporates. Our signalling model offers a different but closely related mechanism applied to corporates similarly rooted in information asymmetries.

[Eren and Malamud \(2022\)](#) develop a capital structure model in which firms choose currency composition of their debt in a symmetric information setting where debt is issued for its tax benefits. Empirically, they are mainly interested in why global firms borrow in dollars as opposed to other reserve currencies, whereas in this paper our goal is to understand why emerging market firms borrow in foreign currencies as opposed to their local currency. They derive conditions under which all firms issue debt in a dominant currency which depends on the co-movement of the exchange rate and cash flows. This statistic also plays a crucial role in our paper. The tradeoff theory in [Eren and Malamud \(2022\)](#) applies to large, established international firms with diversified cash flows and minimal adverse selection costs (see also [Nikolov, Schmid and Steri \(2021\)](#)). By contrast, the theory developed in the current paper is better suited for emerging market firms with a significant degree of informational asymmetry.

Our paper is also related to the literature that studies currency mismatch on corporate balance sheets and its impact on during severe emerging market currency depreciations. Several theoretical models study the emergence and implications of currency mismatch (e.g. [Jeanne \(2003\)](#), [Caballero and Krishnamurthy \(2003\)](#), among others). Our paper provides information on how cross-sectional firm heterogeneity could impact emergence and consequences of currency mismatches with empirical applications from a number of emerging market currency depreciation episodes and a broad dataset covering multiple emerging market economies. This relates us to other papers in the literature that study such episodes. For example, [Aguilar \(2005\)](#) shows that during the Mexican peso crisis, Mexican firms with higher foreign currency debt were more likely to reduce investment. [Kim, Tesar and Zhang \(2015\)](#) show that during the Asian crisis, Korean firms with more foreign currency debt were more likely to exit. [Niepmann and Schmidt-Eisenlohr \(2021\)](#) show that the probability of being past due on loans is larger during depreciation episodes. [Kohn, Leibovici and Szkup \(2020\)](#) show that financially constraint exporters reallocate sales across markets to mitigate the negative effects. [Du and Schreger \(2022\)](#) show that a higher reliance on foreign currency debt by the corporate sector is associated with higher sovereign default risk. Our results suggest a more nuanced view of local

currency depreciation episodes. Firms with foreign currency debt are actually better positioned to weather these shocks since they are firms with greater quality. A similar result is also present in [Salomao and Varela \(2022\)](#). However, the channels through which the results arise are different, and we focus on a broader set of emerging market economies and local currency depreciation episodes.

Another strand of the literature studies the reasons why firms, especially in emerging markets, borrow in safe haven currencies, especially the dollar at the first place. [Jiang, Krishnamurthy and Lustig \(2021\)](#) and [Kojien and Yogo \(2020\)](#) estimate a dollar convenience yield arising from investor safety demand, lowering borrowing costs in dollars. [Gopinath and Stein \(2020\)](#) argue that dollar invoicing creates a demand for dollar deposits, which leads to dollar loans being cheaper. Using data from Peru, [Gutiérrez, Ivashina and Salomao \(2022\)](#) show that investor demand for safety lowers the dollar deposit rate which banks pass through to loans making them cheaper for borrowers (see also [di Giovanni, Kalemli-Özcan, Ulu and Baskaya \(2021\)](#) for evidence from Turkey). Taking dollar discount as given, [Bruno and Shin \(2017\)](#), [Caballero, Panizza and Powell \(2016\)](#), and [Acharya and Vij \(2022\)](#) show that the propensity to borrow in dollars increases when carry trade is more profitable.³ In our model, firms borrow in safe haven currencies in order to signal their quality, and voluntarily expose themselves to currency risks. Therefore, currency mismatches can still arise in the absence of a motive for carry trade or cost advantages.

We also contribute to the literature on capital structure choice by analyzing different types of debt in an international setting when firms face adverse selection. In the pecking order theory ([Myers and Majluf, 1984](#)), debt is a preferred means of financing because it is less sensitive to adverse selection than equity.⁴ The optimality of debt in the presence of asymmetric information has been established in numerous papers. A number of papers also empirically evaluated the pecking order theory (see, for example, [Franck and Goyal \(2003\)](#), [Helwege and Liang \(1996\)](#), and

³Other papers study firms' choice in borrowing in dollars versus euros. [Eren and Malamud \(2022\)](#) show that the dollar provides a better hedge than the euro during global downturns. [Caramichael, Gopinath and Liao \(2021\)](#) compare borrowing costs in the dollar and the euro with and without currency hedges. In a related context, [Ropele, Gorodnichenko and Coibion \(2022\)](#) document Italian firms' borrowing decision in response to exogenous shocks to inflation expectation.

⁴While this logic still holds in dynamic settings with short-term private information (see [Hennessy et al. \(2010\)](#)), this intuition breaks down with dynamic arrival of long-term information. See, for example, [Morellec and Schuerhoff \(2011\)](#) who show informational asymmetries may not translate into a clear pecking order over securities when investment timing serves as a signalling device. See also [Grenadier and Malenko \(2009\)](#).

Leary and Roberts (2010)). To our knowledge, we are the first ones to provide an international pecking order theory with two types of debt (local and foreign currency) and test it empirically.

2 Corporate local currency debt share and local currency debt risk

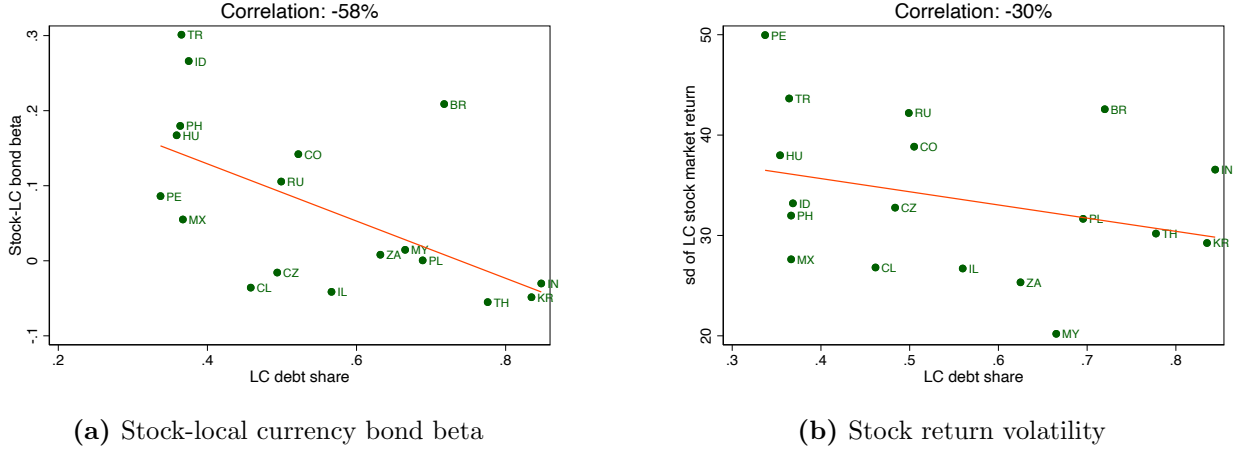
Using aggregate cross-country data, we document two empirical relationships related to emerging market firms' funding currency choice.⁵ First, we use the government local currency bond-stock beta, computed as in Du, Pflueger and Schreger (2020), and show the correlation of local currency share in the aggregate corporate borrowing and the government local currency bond-stock beta. Our results are similar to those of Du, Pflueger and Schreger (2020) for government debt. Given data limitations, constructing measures of local currency corporate bond return is difficult. Nevertheless, the literature has found considerable co-movement between sovereign yields and corporate yields (Mendoza and Yue, 2012; Bedendo and Colla, 2015; Bevilacqua, Hale and Tallman, 2020). As a result, we believe government local currency bond-stock beta is a good proxy for the hedging properties for local currency corporate debt. In a subsequent exercise, we compute the volatility of local-currency stock market return – a measure of the cash-flow uncertainty of emerging market corporates – and relate this measure to the currency choice of emerging market corporates.

Bond-stock beta and corporate local currency share First, we examine the relationship between corporate local currency bond issuance and the hedging benefits of a local currency bond. Following Du, Pflueger and Schreger (2020), we define the country i -specific local-currency bond-stock beta as the coefficient β of the following regression:

$$xr_{i,n,t}^{LC} = \alpha_i + \beta(bond_i, stock_i) \times xr_{i,t}^m + \varepsilon_{i,t}.$$

⁵In the empirical analysis, we use data for firms from 19 emerging market economies. In these aggregate figures, we drop Argentina due to unavailability of reliable data on LC bond spread.

Figure 1: EM financial correlates of corporate local currency debt shares



Note: Panel (a) shows the local currency stock-local currency bond beta of the central government debt versus average corporate local currency debt share for 18 emerging market economies over the sample period 2005-2021. Panel (b) plots the within-year standard deviation of overlapping quarterly local currency stock market return against corporate local currency debt share, with both measures averaged over the sample period 2005-2021. Source for corporate local currency debt share: Capital IQ. Sources for stock price, exchange rate and bond yields: BIS, Bloomberg and Refinitiv.

In this equation, $xr_{i,n,t}^{LC}$ is the log quarterly excess return on local currency long-term bond over domestic short rate (3-month T-bill):

$$xr_{i,n,t+1}^{LC} = r_{i,n,t+1}^{LC} - y_{i,1,t}^{LC}/4,$$

and $r_{i,n,t+1}^{LC}$ is the quarterly log holding period return on local currency long-term bond:

$$r_{i,n,t+1}^{LC} \approx \tau_{i,n,t} y_{i,n,t}^{LC} - (\tau_{i,n,t} - 1/4) \underbrace{y_{i,n-1,t+1}^{LC}}_{\approx y_{i,n,t+1}^{LC}}.$$

On the right-hand side, the excess local-currency stock market return is defined as the log quarterly return on local equity market, denoted $r_{i,t+1}^m$, over log local currency T-bill:

$$xr_{i,t+1}^m = \underbrace{(p_{i,t+1}^m - p_{i,t}^m)}_{r_{i,t+1}^m} - y_{i,1,t}^{LC}/4.$$

We obtain local currency government bond yields and stock market indices from Bloomberg. Following [Du, Pflueger and Schreger \(2020\)](#), we focus on 5-year tenor for local currency bond, so that $\tau_{i,n,t} = 5$ and $n = 20$.

Local currency bond excess return over T-bill captures the cost of government financing. In bad times, stock market return is low (SDF/marginal utility of consumption is high). A *positive* beta corresponds to the case in which local currency bond excess return goes down in bad times, reducing the value of debt repayments for domestic borrowers, so that local currency bonds are good hedging instruments.

Figure [1\(a\)](#) compares local currency bond-stock beta and local currency share in total corporate debt (from Capital IQ), averaged from 2005 to 2021. Compared to DPS, we restrict attention to EM countries, but we also find a strong negative correlation. Corporates whose home countries' government debt has a better hedging property during downturns issue relatively less local currency-denominated debt, forgoing the hedging benefits of local currency. [Du, Pflueger and Schreger \(2020\)](#) rationalizes a similar pattern for government debt by offering a theory of risk-averse lenders and governments' limited commitment over inflation. Our similar observation in the context of corporate borrowing, however, remains puzzling.

Stock return volatility and local currency share of corporate debt A large literature has established the role of information asymmetry and barriers to information transmission in determining capital inflows to emerging markets (see, for example, [Bekaert \(1995\)](#) and [Portes and Rey \(2005\)](#)). Cash-flow uncertainty, measured by stock return volatility, could serve as a rough indicator.⁶ As a complement to our previous finding, we ask if our observation potentially leads to an explanation based on information asymmetry. After computing within-year standard deviation of overlapping quarterly aggregate local-currency stock market return ($r_{i,t+1}^m$), we plot this measure (averaged over 2005 to 2021) against EM corporates' local-currency debt share in Figure [1\(b\)](#). EM firms tend to issue more foreign-currency debt when the local currency-denominated cash flow becomes more uncertain, with a correlation coefficient of -0.3.

⁶Past empirical and theoretical literature highlight the role of private information on stock return volatility. See [French and Roll \(1986\)](#).

3 Model

Motivated by the empirical relationships documented in Section 2, we develop an international corporate finance model in which firms facing adverse selection choose the composition of their debt in local and foreign currency. In such an environment, if firms' cash flows are lower during local currency depreciation episodes, borrowing in foreign currency debt is risky, *and vice versa*. We show that, under natural conditions, there exists a unique separating equilibrium in which the fraction of foreign currency debt is a signal that perfectly reveals firm's type. Better firms effectively take on the FX risk in order to reveal their quality to investors. Hence, our theory also provides a rationale for why emerging market firms do not hedge their currency mismatches.

3.1 Setup

There are two time periods, $t = 0, 1$. A cash-poor firm has an investment project with a fixed investment cost I . It can only finance this project with nominal debt, denominated either in local currency or in foreign currency (for simplicity in exposition, we use \$ in the notations below to refer to foreign currency). At time $t = 1$, when the cash flows X of the firm and the foreign-currency exchange rate $\varepsilon = LC/FC$ are realized, the firm pays out its debt if cash flows are sufficient. Otherwise, it defaults. For simplicity, we assume that the recovery rate in default is zero. We also assume that the foreign-currency exchange rate at $t = 0$ is equal to 1.

Debt markets suffer from a standard adverse selection problem: The firm has a hidden type $\mu \in \mathbb{R}$ that is known to the firm at time $t = 0$, but not to the creditors. The creditors try to filter firm's type from its debt issuance policy. We denote by B and $B_{\$}$, respectively, the face values of local currency- and foreign currency-denominated debt issued by the firm. Then, the total face value in local currency to be paid back to debt-holders is given by $B + \varepsilon B_{\$}$. We use $\alpha = B_{\$}/B$ to denote the quotient of the face values. Similarly, P and $P_{\$}$ denote the prices of local currency- and foreign currency-denominated debt of the firm with face value equal to one unit of the respective currency. Since the firm issues debt to finance its investment, the budget constraint takes the form

$$I = B P + B_{\$} P_{\$} = B (P + \alpha P_{\$}).$$

Defining $\bar{P} \equiv P + \alpha P_{\S}$, we get

$$B = I/\bar{P}.$$

Since the face value B is pinned down by the budget constraint, the only information available to creditors is that in α , the foreign currency-share of total debt face value. Hence, the interest rates $1/P$ and $1/\bar{P}$ offered by creditors only depend on this single variable. In the sequel, we therefore use the notation $P(\alpha)$, $P_{\S}(\alpha)$, $\bar{P}(\alpha)$, $B(\alpha)$, $B_{\S}(\alpha)$. We need the following technical assumption.

Assumption 1 *The random vector (X, μ, ε) of firm cash flows, hidden type, and exchange rate have a joint density $\rho(x, \mu, \varepsilon)$ on $(0, +\infty) \times [\mu_0, \bar{\mu}] \times [\varepsilon_*, \varepsilon^*]$, where ε^* could be infinite.*

We also use $\eta(x|\mu, \varepsilon)$ to denote the density of X conditional on μ, ε . We assume that η is log-concave in x and has the standard monotone likelihood property: $(\log \eta)_{\mu} = \frac{\eta_{\mu}}{\eta}$ is monotone increasing in x . That is, firms' of higher type μ have higher cash flows.

The monotone likelihood property guarantees that an increase in μ leads to a first order stochastic dominance shift in the distribution of X , so that higher μ means a better firm. See Lemma B.2 in the Appendix. We use

$$\Phi(x, \mu, \varepsilon) = \int_0^x \eta(y|\mu, \varepsilon) dy$$

to denote the cumulative distribution function of firm's cash flows conditional on (μ, ε) , and

$$\Psi(x, \mu, \varepsilon) = \int_x^{\infty} (y - x) \eta(y|\mu, \varepsilon) dy$$

to denote the expected cash flows in excess of a level x , conditional on (μ, ε) .

Lenders offer to firms price schedules based on α and α only. We assume that all market participants are risk neutral and fully rational, and discount future at zero rate. Under this assumption, bond prices are given by

$$P(\alpha) = E[(1 - \Phi(Z(\alpha, \varepsilon), \mu, \varepsilon))|\alpha], \quad P_{\S}(\alpha) = E[\varepsilon(1 - \Phi(Z(\alpha, \varepsilon), \mu, \varepsilon))|\alpha]$$

because the firm defaults if and only if cash flows X are below the total debt face value, as given by

$$Z(\alpha, \varepsilon) \equiv B(\alpha) + \varepsilon B_{\S}(\alpha) = (1 + \alpha\varepsilon)B(\alpha) = (1 + \alpha\varepsilon)I/\bar{P}(\alpha),$$

with $\bar{P}(\alpha) = P(\alpha) + \alpha P_{\S}(\alpha)$. As we do not put restrictions on the exchange rate a priori, we do not assume that foreign currency borrowing has an inherent cost advantage. We also note that, conditional on α , shareholders' equity value is given by

$$E[\Psi(Z(\alpha, \varepsilon), \mu, \varepsilon)].$$

3.2 Characterization of equilibrium

We focus our analysis on fully revealing, separating equilibria.⁷ In this class of equilibria, lenders internalize the issuance decision of the firms by offering price schedules $P(\alpha)$ and $P_{\S}(\alpha)$ based on the anticipated firms' type. In other words, α perfectly signals firm's hidden type μ for those firms that are able to raise enough funds to finance I . To allow for rationing, we study monotone threshold rationing equilibria in which all firms of type μ above an equilibrium threshold μ_* get financing.⁸

Definition 3.1 *A separating monotone equilibrium (henceforth, equilibrium) is given by*

- a rationing threshold $\mu_* \geq \mu_0$;
- a strictly monotone, continuously differentiable function $A(\mu) : [\mu_*, \bar{\mu}] \rightarrow \mathbb{R}_+$ defining the fraction of foreign-currency debt issued by the firm of type μ with the inverse function $\mu(\alpha)$ such that:

$$\begin{aligned} & - \text{if } A \text{ is monotone increasing, then } \mu(\alpha) : [\alpha^*, +\infty] \rightarrow [\mu_*, \bar{\mu}] \text{ such that } \mu(\alpha_*) = \\ & \mu_*, \mu(\infty) = \bar{\mu} \end{aligned}$$

⁷As is well-known, signaling models often feature multiple equilibria. We focus on the class of separating equilibria, following DeMarzo and Duffie (1999). The results of our empirical analysis in Section 4 suggest that the separating equilibrium is indeed the relevant equilibrium in the data.

⁸We only consider equilibria in which all pricing functions are continuously differentiable with respect to α .

- if A is monotone decreasing, then $\mu(\alpha) : [0, \alpha^*] \rightarrow [\mu_*, \bar{\mu}]$ such that $\mu(0) = \bar{\mu}$, $\mu(\alpha^*) = \mu_*$
- out-of-equilibrium beliefs: for firms that choose $\alpha < \alpha^*$ in the increasing equilibrium or $\alpha > \alpha^*$ in the decreasing equilibrium, creditors believe that they have a type $\mu = \mu_*$.⁹
- debt pricing functions are rational and satisfy

$$P(\alpha) = E[(1 - \Phi(Z(\alpha, \varepsilon), \mu(\alpha), \varepsilon))], \quad P_{\S}(\alpha) = E[\varepsilon(1 - \Phi(Z(\alpha, \varepsilon), \mu(\alpha), \varepsilon))], \quad (1)$$

where $\mu(\alpha) = A^{-1}(\alpha)$ if the inverse of $A(\mu)$;

- the fraction $A(\mu)$ is optimal for the firm given the debt pricing functions (1):

$$A(\mu) = \arg \max_{\alpha > 0} E[\Psi((1 + \alpha\varepsilon)I/\bar{P}(\alpha), \mu, \varepsilon)]. \quad (2)$$

and

$$\max_{\alpha > 0} E[\Psi((1 + \alpha\varepsilon)I/\bar{P}(\alpha), \mu, \varepsilon)] \geq I$$

if and only if $\mu \geq \mu_*$.

Note that there is a complete symmetry between the foreign currency and local currency in our model.¹⁰ Indeed, instead of ε , consider $\tilde{\varepsilon} \equiv \varepsilon^{-1}$, the FC/LC exchange rate, and let $\tilde{X} \equiv X/\varepsilon$ be the firm cash flows denominated in foreign-currency. By direct calculation, the conditional density of \tilde{X} is given by $\tilde{\eta}(\tilde{x}|\mu, \tilde{\varepsilon}) = \tilde{\varepsilon}^{-1}\eta(\tilde{\varepsilon}^{-1}\tilde{x}|\mu, \tilde{\varepsilon})$ and we can similarly define the functions $\tilde{\Phi}$ and $\tilde{\Psi}$:

$$\tilde{\Phi}(\tilde{x}, \mu, \tilde{\varepsilon}) = \int_0^{\tilde{x}} \tilde{\eta}(y|\mu, \tilde{\varepsilon}) dy$$

and

$$\tilde{\Psi}(\tilde{x}, \mu, \tilde{\varepsilon}) = \int_{\tilde{x}}^{\infty} (y - \tilde{x})\tilde{\eta}(y|\mu, \tilde{\varepsilon}) dy.$$

⁹This assumption ensures that it is never optimal for a firm to choose α outside the respective interval.

¹⁰We provide more details on the symmetry in Appendix A.

We can also define

$$P_*(\tilde{\alpha}) = E[(1 - \tilde{\Phi}(Z(\alpha, \tilde{\varepsilon}), \mu, \tilde{\varepsilon}))|\tilde{\alpha}], \quad P_{\S,*}(\tilde{\alpha}) = E[\tilde{\varepsilon}^{-1}(1 - \Phi(Z(\tilde{\alpha}, \tilde{\varepsilon}), \mu, \tilde{\varepsilon}))|\tilde{\alpha}]$$

and

$$\tilde{P}(\tilde{\alpha}) = P_{\S,*}(\tilde{\alpha}) + \tilde{\alpha}P_*(\tilde{\alpha}) = E[\tilde{\varepsilon}^{-1}(1 + \tilde{\alpha}\tilde{\varepsilon})(1 - \Phi(Z(\tilde{\alpha}, \tilde{\varepsilon}), \mu, \tilde{\varepsilon}))],$$

with

$$Z(\tilde{\alpha}, \tilde{\varepsilon}) = \tilde{B}_{\S}(\tilde{\alpha})(1 + \tilde{\alpha}\tilde{\varepsilon}).$$

In particular, $\tilde{P}(\tilde{\alpha}) = \tilde{\alpha}\bar{P}(\tilde{\alpha}^{-1})$. Furthermore,

$$I = \tilde{B}(\tilde{\alpha})P_*(\tilde{\alpha}) + \tilde{B}_{\S}(\tilde{\alpha})P_{\S,*}(\tilde{\alpha}) = \tilde{B}_{\S}(\tilde{\alpha})\tilde{P}(\tilde{\alpha}), \quad \text{and} \quad \tilde{B}_{\S}(\tilde{\alpha}) = I/\tilde{P}(\tilde{\alpha}).$$

Then, we can rewrite firm's objective as

$$\max_{\tilde{\alpha} > 0} E[\tilde{\varepsilon}^{-1}\tilde{\Psi}((1 + \tilde{\alpha}\tilde{\varepsilon})I/\tilde{P}(\tilde{\alpha}), \mu, \tilde{\varepsilon})].$$

This symmetry will allow us to always have a local currency counterpart for every result about foreign-currency debt.

We construct a candidate equilibrium using first order conditions, and then verify that the candidate equilibrium satisfies all the necessary technical conditions. First, we note that (1) immediately implies that

$$\bar{P}(\alpha) = E[(1 + \varepsilon\alpha)(1 - \Phi((1 + \alpha\varepsilon)I/\bar{P}(\alpha), \mu(\alpha), \varepsilon))]. \quad (3)$$

Define $F(x, y)$ implicitly to be the unique¹¹ solution to

$$x = E[(1 + \varepsilon y)(1 - \Phi((1 + \varepsilon y)I/x, F(x, y), \varepsilon))].$$

¹¹Uniqueness follows because, by the monotone likelihood property, Φ is monotone decreasing in μ .

Then, (3) yields the following result.

Lemma 3.2 *In a separating equilibrium, the inverse $\mu(\alpha) = A^{-1}(\alpha)$ of the optimal policy is given by*

$$\mu(\alpha) = F(\bar{P}(\alpha), \alpha).$$

We now derive an equation for $\bar{P}(\alpha)$. To this end, we use the first order conditions for the firm in (2): At an interior optimum of $\max_{\alpha} E[\Psi(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)]$, we get that the first order condition defining the candidate optimum $\alpha = A(\mu)$ is given by

$$-E[(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon))(B'(\alpha)(1 + \varepsilon\alpha) + B(\alpha)\varepsilon)] = 0,$$

and, in equilibrium, this condition must hold for $\mu = F(\bar{P}(\alpha), \alpha)$. Substituting $B(\alpha) = I/\bar{P}(\alpha)$ and using (3), we can characterize the equilibrium price of debt.

Proposition 3.3 *In any candidate equilibrium, the price $\bar{P}(\alpha)$ satisfies the ordinary differential equation*

$$\bar{P}'(\alpha) = E[\varepsilon(1 - \Phi((I/\bar{P}(\alpha))(1 + \varepsilon\alpha), F(\bar{P}(\alpha), \alpha), \varepsilon))], \quad (4)$$

and the corresponding candidate equilibrium $\mu(\alpha)$ is given by $\mu(\alpha) = F(\bar{P}(\alpha), \alpha)$.

With equation (4), we can now derive sufficient conditions for monotone equilibria. Intuitively, a firm's decision to issue foreign-currency debt will depend on the risk profile of ε – whether foreign-currency appreciation is associated with higher (respectively, lower) expected cash flows. Reducing currency mismatches is consistent with the traditional hedging motive – doing so would reduce the probability of default due to debt revaluation. However, in a separating equilibrium, taking on currency mismatches potentially leads to better financing conditions as creditors respond to the revealed types of higher-quality firms.

Recall that $\tilde{\varepsilon} = \varepsilon^{-1}$, $\tilde{X} \equiv X/\varepsilon$, and $\tilde{\eta}(\tilde{x}|\mu, \tilde{\varepsilon}) = \tilde{\varepsilon}^{-1}\eta(\tilde{\varepsilon}^{-1}\tilde{x}|\mu, \tilde{\varepsilon})$. The following proposition confirms that the signaling motive could dominate in equilibrium.

Proposition 3.4 *The following is true.*

- if $(\log \tilde{\eta})_{\tilde{x}\tilde{x}} < 0$, then any candidate equilibrium $\mu(\alpha)$ from Proposition 3.3 is monotone decreasing in α ;
- if $(\log \eta)_{\varepsilon\varepsilon} < 0$, then any candidate equilibrium $\mu(\alpha)$ from Proposition 3.3 is monotone increasing in α .

Furthermore, in any equilibrium, firm equity value

$$E(\mu) \equiv E[\Psi((1 + A(\mu)\varepsilon)I/\bar{P}(A(\mu)), \mu, \varepsilon)] \quad (5)$$

is monotone increasing in μ .

The conditions of Proposition 3.4 are best understood with the example of a jointly Gaussian distribution. If (x, ε) are jointly normally distributed, then $x|\varepsilon \sim N(\bar{x} + \beta\varepsilon, \sigma^2)$, where the sign of β coincides with that of $\text{Cov}(x, \varepsilon)$. Thus, by direct calculation, $(\log \eta(x, \varepsilon))_{x\varepsilon} = (-0.5(x - (\bar{x} + \beta\varepsilon))^2/\sigma^2)_{x\varepsilon} = \beta/\sigma^2$. As a result, $(\log \eta(x, \varepsilon))_{x\varepsilon} < 0$ implies a negative correlation between x and ε . In this case, foreign-currency appreciation is associated with lower expected cash flows. This is the typical situation for many emerging market firms. These firms, according to Proposition 3.4, would choose to voluntarily forgo their natural hedges and borrow in foreign currency if their hidden types are sufficiently high to allow them to generate higher cash flows. Lemma 3.5 provides a method to construct the equilibrium we characterized:

Lemma 3.5 *The unique candidate monotone decreasing equilibrium (that is, an equilibrium in which high α signals a bad type) is constructed as follows. First, using $\mu(0) = \bar{\mu}$ we find $\bar{P}(0)$ as the unique solution to*

$$\bar{P}(0) = E[(1 - \Phi(I/\bar{P}(0), \bar{\mu}, \varepsilon)].$$

Then, $\bar{P}(\alpha)$ is defined as the unique solution to the ODE (4). And then, α^* is defined as the unique solution to

$$E(\mu(\alpha^*)) = I,$$

where $E(\mu)$ is defined in (5). In the monotone increasing equilibrium, we first do the transformation to $\tilde{\alpha} = 1/\alpha$ and then proceed as above.

Guided by Lemma 3.5, Figure 2 plots the equilibrium fraction of foreign currency as a function of both the hidden types of the firms, and firms' cash flow sensitivity to exchange rate. For the purpose of illustration, we focus on the increasing equilibrium and assume the conditional cash flow is log-normally distributed with condition mean given by $f(\mu, \varepsilon) = \mu - \delta \log \varepsilon$ with $\delta > 0$. A higher value of δ thus leads to a more negative covariance between cash flows and foreign-currency appreciation.¹²

Figure 2 displays the equilibrium forces at work. The traditional hedging motive still exists in our model: all firms, regardless of hidden types, would like to reduce borrowing in foreign currency if local currency depreciation leads to a larger decline in future cash flows. However, with adverse selection, firm's hedging motive is outweighed by the incentive to signal a high repayment ability, as doing so effectively reduces the debt burden on the firm ex ante.¹³

To complete the analysis, we need to verify the second order conditions of the firm. We impose mild restrictions to ensure that the candidate optimum satisfying the first order conditions is indeed the true global optimum. It turns out that these second order conditions can be described explicitly in terms of the dependence of the conditional density η on (μ, ε) .

Proposition 3.6 *The following is true.*

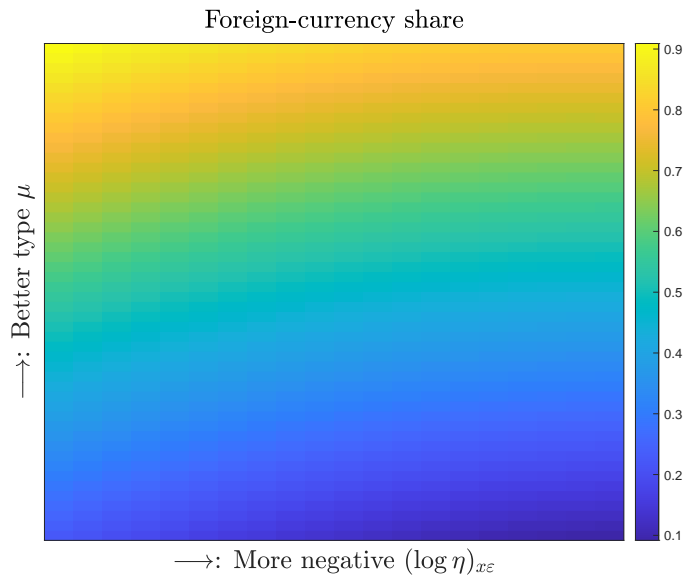
- if $(\log \eta)_{x\varepsilon} \leq 0$ and $(\log \tilde{\eta})_{\tilde{x}\tilde{\varepsilon}} \geq 0$ and $(\log \tilde{\eta})_{\mu\tilde{\varepsilon}} \geq 0$, then any candidate equilibrium is monotone increasing in α and is a true equilibrium;
- if $(\log \tilde{\eta})_{\tilde{x}\tilde{\varepsilon}} \leq 0$ and $(\log \eta)_{x\varepsilon} \geq 0$ and $(\log \eta)_{\mu\varepsilon} \geq 0$, then any candidate equilibrium is monotone decreasing in α and is a true equilibrium.

Finally, to connect the model with our empirical analysis, we prove a theoretical result about the link between ex-ante and ex-post sensitivity of the stock price to the exchange rate. Consider

¹²We assume that $\eta(x|\mu, \varepsilon) = \frac{1}{\sqrt{2\pi}\sigma x} e^{-(\log x - f(\mu, \varepsilon))^2 / (2\sigma^2)}$, so that $(\log \eta)_{x\varepsilon} = x^{-1} f_\varepsilon(\mu, \varepsilon) / \sigma^2 = -(\varepsilon x)^{-1} \delta / \sigma^2$.

¹³In the Appendix, we show that our model is able to numerically replicate the positive correlation between stock return volatility and foreign-currency share documented by Figure 1(b) at the aggregate level.

Figure 2: Foreign-currency share, sensitivity to depreciation, and firm type



Note: This figure numerically illustrates the equilibrium foreign currency share as a function of hidden type and cash flow sensitivity to exchange rate. The colors on the heatmap represent equilibrium foreign-currency share chosen by firms of type μ under different values of $(\log \eta)_{x\varepsilon}$. We focus on an increasing equilibrium and assume cash flows are conditionally log-normal with parameters $(\mu_\varepsilon, \sigma_\varepsilon)$: $\eta(x|\mu, \varepsilon) = \frac{1}{\sqrt{2\pi}\sigma_\varepsilon} e^{-(\log x - f(\mu, \varepsilon))^2 / (2\sigma_\varepsilon^2)}$, with the conditional mean function given by $f(\mu, \varepsilon) = \mu - \delta \log(\varepsilon)$, $\delta \in [5, 6]$. A higher δ corresponds to a more negative $(\log \eta)_{x\varepsilon}$, and thus a larger sensitivity of cash flow to local currency depreciation. The unconditional distribution of the exchange rate is also assumed to be log-normal. Foreign-currency share is expressed as a fraction by transforming the face value ratio α using the transformation $(\alpha^{-1} + 1)^{-1}$. Parameter values are given by: $\varepsilon_* = e^{-0.25}$, $\varepsilon^* = e^{0.25}$, $\mu_\varepsilon = 0.5$, $\sigma_\varepsilon = 0.5$, $\sigma = 0.1$, $I = 0.5$.

the expected equity value conditional on the realization of the exchange rate shock ε . It is given by $\Psi(B(\alpha)(1 + \varepsilon\alpha), \mu(\alpha), \varepsilon)$. The following result shows that the sign of the co-movement between equity value and ε coincides with that of the cash flows, as captured by the sign of $\log \eta_{x\varepsilon}$.

Proposition 3.7 *If $\log \eta_{x\varepsilon} > 0$ then*

$$\frac{\partial}{\partial \varepsilon} \Psi(B(\alpha)(1 + \varepsilon\alpha), \mu(\alpha), \varepsilon) > 0,$$

and the sign changes to negative when $\log \tilde{\eta}_{\tilde{x}\tilde{\varepsilon}} > 0$.

4 Empirical evidence

We test the main predictions of the theory in multiple settings. The signalling channel of foreign currency borrowing predicts that firms optimally expose themselves to currency risk to signal their quality to investors. Crucially, another novel prediction is that signalling properties of foreign currency debt depends on whether cash flows of firms co-move negatively or positively with the value of the foreign currency - the dollar in our empirical setting. Firms whose cash flows are negatively correlated with the dollar (i.e. negative beta firms) signal their quality to investors by borrowing *more* in foreign currency. On the other hand, firms with a positive cash flow co-movement with the dollar (i.e. positive beta firms) signal their quality by borrowing *less* in foreign currency. In the presence of information asymmetries, currency mismatches help firms reveal their types to investors, but such signals come at a cost. This leads to firm-level credit UIP deviations. Using the available information on the prices of firms' debt within our dataset, we also provide evidence that is in line with the predictions of our model.

We structure this section as follows. To start, we describe the dataset that is relatively underused in the literature, highlight its novel uses in our setup and report relevant summary statistics. Building up from granular outstanding debt data, we construct measures that correspond to those in the model. Next, we focus on negative beta firms, those with negative cash-flow co-movement with the dollar, as these firms constitute a large majority of our sample. Leveraging the panel structure, we use a battery of fixed effects ($Country * Industry * Year * Quarter$ and $Firm$) and firm-time level information to single out both the level and the changes of foreign currency share of debt as predictor of future performance. We rule out several alternative explanations through a number of robustness checks. Through event studies, we show that among negative beta firms, those that had a greater foreign currency debt share performed better during large local currency depreciation episodes; a counter-intuitive result which can be explained through our model. Finally, we show that in line with the distinctive prediction of the theory, there is a dichotomy between positive and negative beta firms since these firms expose themselves to currency risk differently. Higher foreign currency share predicts worse performance for positive beta firms in stark contrast to negative beta firms.

4.1 Data and summary statistics

We obtain firm-level balance sheet information from S&P Capital IQ database. In its debt capital structure module, Capital IQ reports outstanding debt instruments issued by a global set of firms and provides information on the type, principal due, coupon rate, maturity and repayment currency of each security. Compared with other firm-level datasets on global debt issuance, Capital IQ tracks the stock of outstanding debt on each firm’s balance sheet, and include a wide range of securities beyond external bond issuance and syndicated borrowing.¹⁴

We focus on non-financial firms from 19 major emerging market economies with flexible exchange rate regimes using yearly data between 2005 and 2021.¹⁵ The empirical counterpart to α in Section 3 is foreign-currency debt outstanding as a share of total outstanding debt reported in the debt capital structure module. For firm f in year t , the foreign-currency share of its outstanding debt, *foreign currency share* $_{f,t}$, is defined as

$$\text{foreign currency share}_{f,t} = \frac{\sum_{i \neq LC} \text{Debt Outstanding}_{i,f,t}}{\sum_i \text{Debt Outstanding}_{i,f,t}} * 100$$

where $\text{Debt Outstanding}_{i,f,t}$ is firm f ’s outstanding debt denominated in currency i , and LC denotes local currency. We also define “hard-currency” share analogously as the share of outstanding debt denominated in a set of advanced economy currencies (USD, GBP, CHF, EUR and JPY).

Our model establishes a strong link between cash flow sensitivity of firms to exchange rate shocks and firms’ foreign-currency borrowing. Proposition 3.7 furthers shows that the direction of the co-movement between cash flows and the exchange rate in the model can be measured by the sensitivity of stock prices to exchange rate shocks. To calculate firm-level β between stock return and local currency depreciation, we merge our sample with monthly firm-level stock price information obtained from Thompson Reuters Worldscope (via ISIN) and country-level bilateral exchange rate against U.S. dollar from BIS.

For each period t and each firm, the stock return-depreciation β is estimated by regressing

¹⁴Kim (2019), Kim, Mano and Mrkaic (2020) and Du and Schreger (2022) also use Capital IQ data to construct currency breakdown of outstanding corporate debt at the firm and country level.

¹⁵The countries are Argentina, Brazil, Chile, Colombia, Czech Republic, Hungary, Indonesia, Israel, India, Korea, Mexico, Malaysia, Peru, Philippines, Poland, Russia, Thailand, Turkey and South Africa.

overlapping quarterly stock return on quarterly local currency depreciation against the U.S. dollar, within a recursive window up to time t .¹⁶ To form our baseline sample for predictive panel regressions, we compute Newey-West standard errors and test the null hypothesis that the β is statistically less or equal to zero.

We utilize a large set of firm-level financial variables to put together our predictive regressions. Firm-level outcomes include earnings before interest and taxes (EBIT), normalized by total assets, as well as log capital expenditures. Firm-specific information set includes yearly stock returns, market cap (from Worldscope), Altman z -score, firm size proxied by total liabilities, current level of log capex, and current ratio, defined as total current assets divided by total current liabilities. We winsorize the financial variables at 2.5% and 97.5% to alleviate the impact of outliers.

Table 1 reports summary statistics. According to Panel (a), the average foreign-currency share of total debt is 15%, mostly comprised of hard currencies. Panel (b) reports statistics on the estimated rolling- β s. Consistent with intuition, over 90% of observations have a negative correlation between stock return and local currency depreciation. Moreover, for most of the positive- β observations, we cannot reject the null hypothesis (at 5% level) that the β is less than or equal to zero. Table 2 checks if the firms in our sample differ along the dimension of foreign-currency borrowing (α) and cash flow sensitivity to exchange rate (β). Consistent with prior literature, Panel (a) suggests that on average, firms that borrow in foreign currency tend to be larger (measured by total assets or earnings). Meanwhile, however, they are financially less stable compared to their peers that only borrow in local currency, as indicated by a relatively smaller current ratio and z -score. Panel (b) compares an average firm with a positive stock return-depreciation β to an average firm with a negative β . Firms with a negative β are on average slightly larger than positive- β firms but have relatively smaller current ratio and z -score. Positive- β firms on average has a larger foreign-currency share out of total debt, consistent with the idea that these firms may have operational hedges.

¹⁶We estimate the rolling β using monthly stock prices and exchange rates. To alleviate the concern on small-sample biases, the minimum recursive window size is set to be 48 months. For windows narrower than 48 months, we impute the β using the estimates from the 48-month window. The average window size is 102 months.

Table 1: Summary statistics

Panel (a): Financial variables and foreign-currency share

Variable	Obs	Mean	Std. Dev.	Min	Max	P50
foreign currency share (%)	103206	15.17	29.448	0	100	0
hard currency share (%)	103206	11.506	26.745	0	100	0
fc share (bank loan, %)	95245	16.497	31.361	0	100	0
EBIT / total assets (%)	102996	4.498	9.899	-32.482	27.796	5.047
log total asset (mil. USD)	103196	4.857	2.003	-8.061	12.921	4.708
log total liabilities (mil. USD)	103205	4.091	2.143	-7.201	12.109	3.973
current ratio	103178	1.926	1.833	.133	11.612	1.395
z-score	97066	2.834	2.743	-1.989	13.283	2.254
annual stock return (%)	96905	18.549	69.562	-71.429	260.082	.897
log capex (mil. USD)	99425	1.254	2.66	-13.633	10.824	1.311
log market cap (mil. USD)	99906	4.199	2.178	-4.343	13.133	4.031

Panel (b): Stock return-depreciation beta for each firm

Variable	Obs	Mean	Std. Dev.	Min	Max	P50
negative betas	93500	-1.881	1.997	-148.824	0	-1.478
positive betas	9706	.897	1.859	0	42.46	.462
positive betas, insignificantly > 0	8565	.749	1.553	0	36.912	.397

Note: This table reports summary statistics for the key variables used in the empirical analysis. Panel (a) focuses on firm-level balance sheets. Foreign-currency share is the share of outstanding debt denominated in currencies other than a firm's local currency. Hard currency is defined as one of CHF, EUR, GBP, JPY, or USD. Bank loan contains two types of instruments: term loans and credit lines. Current ratio is defined as the ratio between current assets and current liabilities. The financial variables are winsorized at 2.5% and 97.5%. Panel (b) reports summary statistics for the stock return-depreciation betas. For each firm, monthly observations from Worldscope is used to regress overlapping quarter-over-quarter stock return on quarter-over-quarter local currency depreciation against U.S. dollar. The rolling betas are generated using all available information from 2000 and a recursive window. β insignificantly larger than zero refers to observations for which we cannot reject the null hypothesis that they are less or equal to zero, with confidence intervals computed using Newey-West standard errors.

Table 2: Firm characteristics by foreign-currency share or sign of β

Panel (a): by zero or positive foreign-currency share

	zero fc share		non-zero fc share		mean diff.
	mean	sd	mean	sd	t
EBIT / total assets (%)	4.13	(10.35)	5.20	(8.93)	-16.61
log total asset (mil. USD)	4.29	(1.76)	5.94	(1.99)	-136.81
log total liabilities (mil. USD)	3.46	(1.91)	5.29	(2.05)	-142.01
current ratio	2.08	(2.04)	1.64	(1.30)	36.70
z-score	3.05	(2.97)	2.43	(2.22)	33.76
annual stock return (%)	19.28	(71.50)	17.21	(65.83)	4.42
log market cap (mil. USD)	3.67	(1.99)	5.18	(2.18)	-110.37
log capex (mil. USD)	0.55	(2.47)	2.56	(2.50)	-121.83
β (negative)	-1.98	(2.18)	-1.69	(1.58)	-21.25
β (positive)	0.94	(1.93)	0.81	(1.71)	3.35
β (positive, insignificantly > 0)	0.76	(1.45)	0.71	(1.75)	1.38
Observations	67714		35492		103206

Note: See notes after Panel (b) for details on definitions of indicators.

4.2 Evidence on negative beta firms

In this section, we focus on negative beta firms as they comprise a significant share of the dataset.¹⁷

A negative co-movement of cash flows and the dollar exchange rate means that these firms are worse off when the dollar appreciates. According to our model, firms have incentives to take on this risk by borrowing more in foreign currency to signal their quality to their investors in the presence of

¹⁷Since these beta are estimated variables, in the results reported in the main text, we categorize firms with negative beta as those for which the null hypothesis that β is less than or equal to zero is not rejected at 5% confidence level. We compute the confidence interval using Newey-West standard errors with 3 lags. Those for which it is rejected are classified as positive beta firms. We report the results with the classification using only the coefficient estimates without hypothesis testing in the appendix. The results are largely similar.

asymmetric information. In what follows, we test if firms with a higher level or change in foreign currency share of debt perform better. We present evidence in line with the predictions of the model, first using the panel structure and then through event studies.

Table 2: Firm characteristics by foreign-currency share or sign of β (cont'd)

Panel (b): By sign of β

	$\beta < 0$		$\beta > 0$		$\beta > 0$, insignificant	
	mean	sd	mean	sd	mean	sd
EBIT / total assets (%)	4.62	(9.71)	3.27	(11.49)	3.12	(11.52)
log total asset (mil. USD)	4.91	(1.99)	4.31	(2.00)	4.27	(1.95)
log total liabilities (mil. USD)	4.15	(2.14)	3.48	(2.11)	3.46	(2.04)
current ratio	1.91	(1.82)	2.09	(1.97)	2.08	(1.96)
z-score	2.80	(2.70)	3.16	(3.09)	3.13	(3.08)
annual stock return (%)	18.41	(69.30)	20.01	(72.13)	19.85	(72.08)
log market cap (mil. USD)	4.23	(2.19)	3.94	(2.08)	3.89	(2.02)
log capex (mil. USD)	1.31	(2.65)	0.73	(2.72)	0.68	(2.68)
foreign currency share (%)	14.96	(29.13)	17.20	(32.25)	16.35	(31.59)
Observations	93500		9706		8565	

Note: Panel (a) of Table 2 compares balance sheet indicators between firms with zero or positive foreign-currency borrowings. Foreign-currency share is the share of outstanding debt denominated in currencies other than a firm's local currency. Panel (b) makes the comparison among firms with positive stock return-depreciation β s versus firms with negative β s as well as firms with positive β s insignificantly larger than zero from a one-sided t -test using Newey-West standard errors. The β s are computed using monthly data on overlapping three-month stock return (obtained from Worldscope) and three-month local currency depreciation (obtained from BIS). The financial variables are winsorized at 2.5% and 97.5%.

4.2.1 Panel data analysis

We use the panel structure of our dataset and test whether the foreign currency share of liabilities of a firm at a given period can predict the “hidden” information on firms' quality. We map the theory to data by testing whether foreign currency borrowing predicts future performance measured by earnings before interest and taxes normalized by assets, i.e. $\frac{EBIT}{Assets}$. It is crucial that interest

payments are not included since it is endogenous to the choice of debt structure. In alternative specifications, we use levels and changes in foreign currency borrowing as predictors of future performance since firms could in principle signal both via high foreign currency debt share or increases in it. Both specifications lend support to our predictions. Moreover, we find that a greater increase in foreign currency debt share also predicts higher future capital expenditures. We rule out alternative explanations through a number of robustness checks. We also use other potential signalling variables identified in the literature as control variables, pointing to a signalling power of the foreign currency debt share on its own.

We first report the results with the levels of foreign currency debt share. We use the following specification as the baseline, restricting our sample to firms that have at least once borrowed in foreign currency:¹⁸

$$\frac{EBIT_{f,t+1}}{Assets_{f,t+1}} = \beta_1(\Delta)foreign\ currency\ share_{f,t} + \beta_2\frac{EBIT_{f,t}}{Assets_{f,t}} + \beta_3yoy\ stock\ return_{f,t} + \beta_4Other\ Firm\ Controls_{f,t} + \eta_{c(f),i(f),t} + \gamma_f + \epsilon_{f,t}$$

Across various specifications that we report in Table 3, we keep a rich set of control variables and fixed effects. These variables intend to restrict the comparison to firms that are similar in terms of observable characteristics and capture publicly available information that might available to investors to predict these firms’ earnings. We use *Country*Industry*Year*Quarter* interaction fixed effects in order to absorb variation along these dimensions and compare firms within the same country and industry in a given year and quarter.¹⁹ In addition, we use firm fixed effects to take out average performance differences across firms. Finally, we use an extensive selection of control variables to endow investors with a rich information set. In particular, we control for year-on-year stock returns between year $t - 1$ and t and the market capitalization of the firm in year t (computed

¹⁸We restrict our attention to such firms with “access” to foreign currency borrowing in order to rule out a potential selection mechanism that might drive both foreign currency borrowing and performance. Nonetheless, the results are similar if we also include firms that we classify as “no access” firms in the analysis.

¹⁹In our yearly panel, firms report at the end of their fiscal year. This results in firms reporting in different quarters. Adding the quarter interaction corrects for any potential bias arising from this inconsistency.

using the companies' period-end stock prices) in order to account for any information about future performance that is already reflected in the firm's stock returns and valuations. Crucially, we also include the current level of $\frac{EBIT_{f,t}}{Assets_{f,t}}$ to control for potential persistence in earnings.²⁰ We also control for the local currency stock return-dollar β . Other financial controls include log liabilities, log capital expenditures, Altman's z-score, and current ratio at year t . We cluster standard errors at the industry level.²¹

Previous literature has identified total debt and investment as two potential signalling variables that firms use in their corporate finance decisions. See, e.g., [Hennessy et al. \(2010\)](#), [Morellec and Schuerhoff \(2011\)](#), [Grenadier and Malenko \(2009\)](#). By controlling for log liabilities and log capital expenditures, we take into account the possibility that firms might signal also through these variables. Therefore, we interpret any residual predictive power of foreign currency share of debt as a signalling device on its own beyond other potential signalling devices proposed in the literature.

We report the results of various specifications in Table 3.²² We vary the measurement of the *foreign currency share* $_{f,t}$, use different subsamples for robustness checks and predict future capital expenditures in addition to $\frac{EBIT}{Assets}$. In column (1), we present the baseline results. In column (2), we use *hard currency share* $_{f,t}$ which is constructed similar to *foreign currency share* $_{f,t}$, but with only USD, EUR, CHF, GBP and JPY in the numerator. Borrowing in these currencies not only generate a currency mismatch, but a substantially riskier one as these currencies tend to appreciate against EM currencies during downturns, potentially intensifying their role in signalling. In column (3), we use *fc share (bank loan)* $_{f,t}$ which is constructed similar to *foreign currency share* $_{f,t}$, but captures only the foreign currency share of bank loans in contrast to total debt as the signalling device. In column (4), we restrict attention only to firms in non-tradable sectors.²³ Since firms in non-tradable sectors only have local currency revenues, we expect our channel to be stronger as

²⁰As firms' reporting practices differ, we avoid look-ahead bias by using stock prices at actual period ends instead of year ends.

²¹Adding additional clusters along dimensions of year and/or country do not substantially change the results, as we show in Table C5. However, adding these dimensions significantly reduce the number of clusters which may not be desirable ([Cameron and Miller, 2015](#)).

²²To give a sense of the sample coverage, over 4800 firms from 19 countries are in the identifying sample of Table 3, column (1).

²³We follow [Aguiar and Gopinath \(2005\)](#) and classify industries with SIC codes 2000-3999 as tradable.

foreign currency borrowing results in currency mismatches that are potentially easier for investors to observe. In column (5), we restrict attention only to “domestic” firms, those that do not have a foreign parent and are only domestically listed. In column (6), we further reduce the sample in (5) to only firms that had a positive foreign currency debt share in each year. In column (7), we use the control variables in the baseline column (1), this time predicting future log capital expenditures. We provide further robustness checks in the appendix varying the performance metrics and also subsamples to ensure our results are not driven by imperfections in data reporting to Capital IQ.²⁴

Across many specifications in Table 3, the foreign currency share of debt positively and statistically significantly predicts one-year ahead $\frac{EBIT}{Assets}$ for negative beta firms. This holds true across different specifications and sub-samples. In terms of magnitudes, controlling for all other firm-level characteristics, a 10 percentage point increase in foreign currency share in year t predicts between 4 and 10 basis points higher $\frac{EBIT}{Assets}$ across different specifications, which corresponds to around 1% to 2.5% of the average value of $\frac{EBIT}{Assets}$ which is around 4 per cent. As we have endowed investors with a large information set with our firm-level controls, our estimates are likely to be conservative.

²⁴We compute percentage discrepancy between total debt reported on the main balance sheets and total outstanding debt aggregated from the security-level capital structure module of Capital IQ, and use this discrepancy measure to create Table C3. We re-run the baseline panel regressions but keep only the firm-year observations within a range of discrepancy. We show that our baseline results are robust, regardless of whether the range is set to be 25%, 10%, 5% or 1%.

Table 3: Signaling channel of foreign-currency debt (levels): Full panel

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic and pos. fc $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\log(\text{capex})_{f,t+1}$
foreign currency share _{f,t} (%)	0.006*** (0.002)			0.010*** (0.003)	0.006*** (0.002)	0.004* (0.002)	0.0004 (0.0002)
hard currency share _{f,t} (%)		0.007*** (0.002)					
fc share _{f,t} (bank loan, %)			0.004** (0.002)				
EBIT _{f,t} / Asset _{f,t} (%)	0.373*** (0.014)	0.373*** (0.014)	0.374*** (0.015)	0.350*** (0.028)	0.379*** (0.014)	0.314*** (0.017)	0.0203*** (0.0018)
yoy stock return _{f,t}	0.007*** (0.001)	0.007*** (0.001)	0.007*** (0.001)	0.008*** (0.002)	0.007*** (0.001)	0.007*** (0.001)	0.0002 (0.0001)
current ratio _{f,t}	-0.367*** (0.047)	-0.367*** (0.047)	-0.387*** (0.053)	-0.242*** (0.080)	-0.356*** (0.050)	-0.309*** (0.097)	0.0601*** (0.0113)
z-score _{f,t}	0.034 (0.047)	0.035 (0.046)	0.018 (0.048)	0.033 (0.068)	0.007 (0.043)	-0.070 (0.069)	-0.0100 (0.0077)
log capex _{f,t}	-0.004 (0.049)	-0.003 (0.049)	0.016 (0.049)	-0.057 (0.067)	-0.008 (0.048)	-0.070 (0.083)	0.3756*** (0.0153)
log total liabilities _{f,t}	-0.874*** (0.150)	-0.872*** (0.149)	-0.938*** (0.147)	-0.345 (0.318)	-0.891*** (0.142)	-1.026*** (0.159)	0.0960*** (0.0352)
log market cap _{f,t}	0.369*** (0.101)	0.370*** (0.101)	0.387*** (0.099)	0.439** (0.205)	0.444*** (0.107)	0.501*** (0.142)	0.3248*** (0.0206)
rolling $\beta_{f,t}$	0.032 (0.029)	0.031 (0.029)	0.021 (0.026)	0.108 (0.074)	0.030 (0.028)	0.033 (0.060)	0.0038 (0.0040)
Observations	48,139	48,139	46,225	15,213	44,367	22,566	47,557
R-squared	0.717	0.717	0.712	0.764	0.710	0.751	0.8994
Country*Industry*Year*Quarter FE	✓	✓	✓	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓	✓	✓	✓
No. clusters	63	63	63	47	63	59	63
No. FEs	11891	11891	11566	5282	11002	7609	11821

Note: Table 3 reports panel regressions relating foreign currency share of outstanding debt to future earnings. The dependent variable is EBIT divided by total assets in the year $t + 1$, expressed as percentages. All independent variables are sampled at year t . The sample period is 2005 to 2021. Our baseline samples are firms with at least one year of positive foreign-currency borrowing in the data. We also require these firms to have a negative rolling β coefficient estimated using a regression of overlapping quarterly stock returns on local currency depreciation at monthly frequency, or a positive β insignificantly larger than zero at 5% level (Newey-West standard errors). Firms' financial variables are winsorized at 2.5 and 97.5 percentile. Column (1) focuses on all firms in our baseline sample and our baseline foreign-currency share measure containing all currencies and all types of borrowing. In column (2) and (3), the key independent variable is hard-currency share (share of CHF, EUR, GBP, JPY and USD) and share of foreign-currency bank loans (term loans and credit lines), respectively. Column (4) restricts the sample to non-tradable firms (Aguar and Gopinath, 2005). Column (5) looks at domestic firms only, defined as firms not listed overseas, and those that do not have an overseas ultimate parent. Column (6) further restricts the domestic-firm sample to observations with positive foreign-currency debt outstanding. In column (7), the dependent variable is log capex. Standard errors are clustered at the industry level. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Different specifications we consider rule out potential alternative explanations.

We rule out the possibility that firms select into foreign currency borrowing and the very

characteristics which allow them to borrow in foreign currencies also help them generate higher returns. To address this concern, we restrict our sample only to firms which have access to FX borrowing during the whole sample, or during each period as in column (6).

Across all specifications, we use $Country * Industry * Year * Quarter$ fixed effects, which allows us to compare firms in the same country, which operate in the same industry, and at a given year and quarter. This rules out any potential time-varying differences across countries or industries that could potentially drive our results. Utilizing only within country-industry-year-quarter variation is conceptually closer to the key mechanism of firm-level asymmetric information highlighted in our model. Moreover, the inclusion of firm fixed effects and firm controls such as current period $\frac{EBIT}{Assets}$ and year-on-year stock returns among others endow investors with a very rich information set singling out the role of foreign currency debt share in predicting firm performance.

We also rule out the possible explanation that foreign currency share of debt positively predicts earnings if a firm were an exporter as exporting firms are typically more productive (see, for example, Melitz (2003)). Previous literature suggests that non-exporting firms indeed tend to borrow in foreign currencies (Ranciere, Tornell and Vamvakidis (2014), Kim, Tesar and Zhang (2015), Salomao and Varela (2022)). Since we restrict the sample to negative beta firms (firms whose cash flows move negatively with the dollar appreciation), this is unlikely to be a large concern, since we would expect exporters to have a positive beta (weaker local currency increases their competitiveness in foreign markets). To further alleviate this concern, we restrict our attention to firms in non-tradable sectors in column (4) and the results not only go through but the point estimate is greater.

Finally, the fact that the results go through when we measure the foreign currency share using bank loans only is reassuring since we expect information asymmetries to be present regardless of whether the lender is a bank or not. The coefficient when we use bank loans only is slightly smaller, which could be due to information asymmetries/incentives for signalling being arguably more important when it comes to bonds than bank loans.

We repeat the same exercise using year-on-year changes in foreign currency borrowing instead of levels and report them in Table 4. All specifications/columns are similar to those in Table 3

otherwise. The results with changes are to a large extent similar to those with levels. The results in two tables combined suggest that negative beta firms perform better not only when they have higher foreign currency debt share, but also when they increase the foreign currency share of their debt more. These findings are in line with the predictions of our model.

Table 4: Signaling channel of foreign-currency debt (changes): Full panel

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic and pos. fc $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\log(\text{capex})_{f,t+1}$
Δ foreign currency share $_{f,t-1,t}$ (%)	0.004*** (0.001)			0.003 (0.003)	0.004** (0.001)	0.003** (0.002)	0.0004** (0.0002)
Δ hard currency share $_{f,t-1,t}$ (%)		0.005*** (0.002)					
Δ fc share $_{f,t-1,t}$ (bank loan, %)			0.004*** (0.001)				
EBIT $_{f,t}$ / Asset $_{f,t}$ (%)	0.374*** (0.014)	0.374*** (0.014)	0.378*** (0.015)	0.357*** (0.029)	0.380*** (0.014)	0.316*** (0.017)	0.0201*** (0.0018)
yoy stock return $_{f,t}$	0.006*** (0.001)	0.006*** (0.001)	0.006*** (0.001)	0.008*** (0.002)	0.006*** (0.001)	0.007*** (0.001)	0.0002 (0.0001)
current ratio $_{f,t}$	-0.374*** (0.046)	-0.375*** (0.046)	-0.405*** (0.047)	-0.273*** (0.082)	-0.360*** (0.048)	-0.279*** (0.097)	0.0597*** (0.0117)
z-score $_{f,t}$	0.042 (0.047)	0.041 (0.047)	0.022 (0.046)	0.038 (0.068)	0.015 (0.042)	-0.068 (0.074)	-0.0108 (0.0077)
log capex $_{f,t}$	-0.002 (0.049)	-0.001 (0.049)	0.020 (0.052)	-0.061 (0.067)	-0.005 (0.047)	-0.067 (0.087)	0.3781*** (0.0152)
log total liabilities $_{f,t}$	-0.871*** (0.150)	-0.874*** (0.150)	-0.929*** (0.144)	-0.364 (0.324)	-0.888*** (0.143)	-1.018*** (0.171)	0.0929** (0.0363)
log market cap $_{f,t}$	0.381*** (0.103)	0.382*** (0.103)	0.406*** (0.105)	0.447** (0.207)	0.453*** (0.109)	0.530*** (0.150)	0.3291*** (0.0200)
rolling $\beta_{f,t}$	0.033 (0.030)	0.033 (0.030)	0.021 (0.027)	0.108 (0.075)	0.031 (0.029)	0.031 (0.063)	0.0040 (0.0038)
Observations	46,894	46,894	44,173	14,872	43,185	21,938	46,326
R-squared	0.719	0.719	0.715	0.764	0.712	0.753	0.9010
Country*Industry*Year*Quarter FE	✓	✓	✓	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓	✓	✓	✓
No. clusters	63	63	63	47	63	59	63
No. FEs	11783	11783	11311	5212	10901	7505	11716

Note: Table 4 reports panel regressions relating foreign currency share of outstanding debt to future earnings. Compared to Table 3, we use yearly changes in the foreign-currency share as the key predictor. The dependent variable is EBIT divided by total assets in the year $t + 1$, expressed as percentages. All independent variables are sampled at year t . The sample period is 2005 to 2021. Our baseline samples are firms with at least one year of positive foreign-currency borrowing in the data. We also require these firms to have a negative rolling β coefficient estimated using a regression of overlapping quarterly stock returns on local currency depreciation at monthly frequency, or a positive β insignificantly larger than zero at 5% level (Newey-West standard errors). Firms' financial variables are winsorized at 2.5 and 97.5 percentile. Column (1) focuses on all firms in our baseline sample and our baseline foreign-currency share measure containing all currencies and all types of borrowing. In column (2) and (3), the key independent variable is hard-currency share (share of CHF, EUR, GBP, JPY and USD) and share of foreign-currency bank loans (term loans and credit lines), respectively. Column (4) restricts the sample to non-tradable firms (Aguiar and Gopinath, 2005). Column (5) looks at domestic firms only, defined as firms not listed overseas, and those that do not have an overseas ultimate parent. Column (6) further restricts the domestic-firm sample to observations with positive foreign-currency debt outstanding. In column (7), the dependent variable is log capex. Standard errors are clustered at the industry level. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

4.2.2 Event studies

Negative beta firms take on additional FX risk to signal their earnings capabilities. This becomes especially relevant during foreign currency appreciation episodes, which typically corresponds to downturns. In our model, firms that take on more FX risk through a higher share of foreign currency debt are able to weather these episodes better compared to firms with lower foreign currency debt: Controlling for leverage, they generate both higher earnings and higher stock returns.

In this section, we repeat the same exercise keeping episodes of large currency depreciation including but not restricted to the Great Financial Crisis and Covid-19 crisis. We follow the same panel analysis approach and use the same set of fixed effects and control variables. The strength of this specification comes from the fact that we can compare different large depreciation episodes within firms as well testing whether the same firm performed better in a large depreciation episode when it had higher foreign or hard currency debt share. We restrict the sample to periods when the local currency depreciated by more than 10% year-on-year against the dollar between t and $t + 1$ and predict $\frac{EBIT}{Assets}_{f,t+1}$ using *foreign currency share* $_{f,t}$, *hard currency share* $_{f,t}$ and Δ *hard currency share* $_{f,t-1,t}$. Given we restrict the sample to depreciation episodes of the local currency against *the dollar*, we focus mostly on the results with the hard currency share on the right-hand side.

The results are again in line with our predictions, reported in Table 5. Firms with higher foreign currency or hard currency share perform better in terms of higher earnings during large local currency depreciation episodes. This is true in the baseline sample as well as when we restrict the sample further to the non-tradable sectors or domestic firms (i.e. firms that do not have a foreign parent and are not listed abroad). Furthermore, having firm fixed effects as well allows us to make a within-firm statement, that is the same firm had higher earnings across these different episodes if they had a higher foreign currency or hard currency share. In the last column, we also check whether firms perform better when they changed the hard currency share more before going into one episode versus another. The coefficient goes in the predicted direction even in this very restrictive case, albeit statistically insignificant.

Table 5: Event study: Large depreciation episodes (more than 10%)

VARIABLES	(1)	(2)	(3)	(4)	(5)
	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)
foreign currency share $_{f,t}$ (%)	0.007 (0.005)				
hard currency share $_{f,t}$ (%)		0.008* (0.004)	0.015** (0.007)	0.008* (0.004)	
Δ hard currency share $_{f,t-1,t}$ (%)					0.003 (0.004)
Observations	7,590	7,590	2,699	6,805	7,492
R-squared	0.780	0.780	0.825	0.785	0.781
Country*Industry*Year*Quarter FE	✓	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓	✓
Firm-level controls	✓	✓	✓	✓	✓
No. clusters	57	57	37	56	57
No. FEs	3490	3490	1489	3174	3465

Note: Table 5 reports the predictive regressions for firm-year observations characterized by episodes of large local currency depreciation against the U.S. dollar. The dependent variable is EBIT divided by total assets in the year $t + 1$, expressed as percentages. All independent variables are sampled at year t . Observations are included if the yearly currency depreciation exceeds 10 percent from year t to year $t + 1$. The sample period is 2005 to 2021. Our baseline samples are firms with at least one year of positive foreign-currency borrowing in the data. We also require these firms to have a negative rolling β coefficient estimated using a regression of overlapping quarterly stock returns on local currency depreciation at monthly frequency, or a positive β insignificantly larger than zero at 5% level. Firms' financial variables are winsorized at 2.5 and 97.5 percentile. Column (1) focuses on all firms in our baseline sample and our baseline foreign-currency share measure contains all currencies and all types of borrowing. In column (2) to (4), the key independent variable is hard-currency share (share of CHF, EUR, GBP, JPY and USD). Column (3) restricts the sample to non-tradable firms (Aguiar and Gopinath, 2005). Column (4) looks at domestic firms only, defined as firms not listed overseas, and those that do not have an overseas ultimate parent. In column (5), the key independent variable is yearly changes in the hard-currency share. Standard errors are clustered at the industry level. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

4.3 Negative versus positive beta firms

A main distinctive feature of our theory is that in the presence of asymmetric information, firms have incentives to take on currency risk to reveal their hidden quality to their investors. In our model, the use of foreign currency debt to signal depends crucially on the co-movement of cash flows with the bilateral exchange rate of the foreign currency (the dollar in our empirical setup) and the local currency. Our model predicts that firms that do worse when the dollar appreciates (i.e.

negative beta firms) borrow relatively *more* in foreign currencies to signal their quality. On the contrary, firms that do better when the dollar appreciates (i.e.) borrow relatively *less* in foreign currencies to signal their quality (Proposition 3.4). The reason is that signalling in our model operates through currency mismatch. Since positive beta firms are those that are better off during episodes of dollar appreciation, taking more dollar debt would not have any signalling value. Taking more local currency debt would however result in currency risk in the case of positive beta firms. This prediction is unique to our theory. It is also another differentiating factor from [Salomao and Varela \(2022\)](#), since in their model foreign currency debt only adds noise to cash flows and firms have no signalling motive. As a result, no distinction arises between positive and negative beta firms.

The empirical evidence reported in Table 6 is in line with our theoretical predictions. For positive beta firms, a greater change in the foreign currency or hard currency share predicts lower earnings ($\frac{EBIT}{Assets}$). Our empirical tests also point to a dichotomy between positive and negative beta firms as the point estimates are of different sign across all specifications. While the results are only statistically significant when we use changes in foreign currency or hard currency share, point estimates are similar also in levels. The results also go in the same direction for predictions of future capex, however the result for positive beta firms is statistically insignificant.

Table 6: Signaling channel of foreign-currency debt: The role of stock-depreciation β

VARIABLES	(1) $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	(2) $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	(3) $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	(4) $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	(5) $\log(\text{capex})_{f,t+1}$	(6) $\log(\text{capex})_{f,t+1}$
$\beta_{f,t} > 0$, significant	0.623 (0.655)	0.138 (0.617)	0.535 (0.635)	0.136 (0.618)	0.0768 (0.1208)	0.0487 (0.0931)
foreign currency share $_{f,t}$ (%)	0.007*** (0.002)				0.0004 (0.0002)	
FC share \times ($\beta_{f,t} > 0$, significant)	-0.013 (0.009)				-0.0011 (0.0022)	
Δ foreign currency share $_{f,t-1,t}$ (%)		0.004*** (0.001)				0.0005** (0.0002)
Δ FC share \times ($\beta_{f,t} > 0$, significant)		-0.026** (0.011)				-0.0035 (0.0022)
hard currency share $_{f,t}$ (%)			0.007*** (0.002)			
hard currency share \times ($\beta_{f,t} > 0$, significant)			-0.011 (0.010)			
Δ hard currency share $_{f,t-1,t}$ (%)				0.005*** (0.002)		
Δ hard currency share \times ($\beta_{f,t} > 0$, significant)				-0.028*** (0.010)		
Observations	48,668	47,414	48,668	47,414	48,082	46,842
R-squared	0.717	0.719	0.717	0.719	0.8996	0.9012
Country*Industry*Year*Quarter FE	✓	✓	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓	✓	✓
Firm-level controls	✓	✓	✓	✓	✓	✓
No. clusters	63	63	63	63	63	63
No. FEs	12026	11917	12026	11917	11955	11849

Note: Table 6 reports panel regression output relating firms' future earnings to foreign-currency share of borrowings, separating firms with positive stock return-depreciation β s (significantly larger than zero at 5% level, Newey-West standard errors) from those with negative β s or insignificantly positive β s. The dependent variable (columns (1) to (4)) is EBIT divided by total assets in the year $t + 1$, expressed as percentages, and log capex (columns (5) to (6)). All independent variables are sampled at year t . The sample period is 2005 to 2021. In addition to foreign-currency shares, we interact (changes in) foreign-currency share with a dummy indicating whether firm f has a positive rolling β at year t . Firms' financial variables are winsorized at 2.5 and 97.5 percentile. Columns (1) to (4) use foreign-currency share, changes in foreign-currency share, hard-currency share (CHF, GBP, EUR JPY, USD) and changes in hard-currency share as the key predictor. Columns (5) and (6) focus on the predictive relationship between the overall foreign-currency share and log capex. Standard errors are clustered at the industry level. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

4.4 Theory and evidence on the cost of signalling

In our final exercise, we show that both our theory and data supports the conceptualization of foreign-currency borrowing as a costly signaling device. We start with a simple observation that borrowing in FC is relatively more expensive for negative beta firms:

Proposition 4.1 (Credit UIP Deviations) *The UIP credit spread $\log(1/P_{\$}(\alpha)) - \log(1/P(\alpha)) \geq \log E[\varepsilon]$ (respectively, $\leq \log E[\varepsilon]$) if $(\log \eta)_{\varepsilon,x} < 0$ (respectively, $(\log \eta)_{\varepsilon,\bar{x}} < 0$). Furthermore, if the conditional density, $\eta(x|\mu, \varepsilon)$, depends on a parameter β such that $\beta < 0$ (respectively, > 0) corresponds to $(\log \eta)_{\varepsilon,x} < 0$ (respectively, $(\log \eta)_{\varepsilon,\bar{x}} < 0$), and is real analytic in $(\beta, \mu, \varepsilon)$, then the spread $\log(1/P_{\$}(\alpha)) - \log(1/P(\alpha))$ is monotone decreasing in β for β close to zero.*

Proposition 4.1 illustrates a simple form of UIP deviation: For negative beta firms, cash flows are lower, and default is more likely when the foreign currency appreciates. As a result, in percentage terms, foreign bond holders lose more in such states, and require a higher compensation for this risk ex-ante. The compensation is larger the more sensitive firms' cash flow is to foreign-currency appreciation. This mechanism widens the spread between foreign currency and local currency borrowing rates.

In Table 7, we provide evidence in support of this prediction, suggesting that bond investors rationally anticipate the impact of dollar-cash flow correlation on the riskiness of the debt. For firm-year observations with new borrowing in both dollars and the local currency, We compute average interest rates and residual maturity (in years) on dollar-denominated borrowing and local-currency, weighted by the size of each case of borrowing. Similar to our treatment of firm-level outcomes and controls, both variables are winsorized at 2.5% and 97.5% tails.

We then regress the contemporary interest rate difference, $R_{USD} - R_{LC}$ on the rolling stock return-depreciation β , controlling for weighted average residual maturity to account for the term premium of dollar versus local-currency borrowing. The use of country-time fixed effects absorbs the change in the expected depreciation of currency that enters into the UIP term. Column (1) and (2) validate the prediction of the theory, that there is a negative and significant correlation between cash flow sensitivity to exchange rate fluctuations and credit UIP deviations. Saturating

the regressions with the same set of firm-level controls as in previous tables and/or firm fixed effects (columns (3) to (4)) substantially reduces the sample size and statistical power, but the point estimates we get are consistently negative.

Table 7: Costly signaling: Testing model predictions on prices

VARIABLES	(1) USD-LC spread _t (%)	(2) USD-LC spread _t (%)	(3) USD-LC spread _t (%)	(4) USD-LC spread _t (%)
rolling $\beta_{f,t}$	-0.0823** (0.0380)	-0.0802** (0.0372)	-0.0492 (0.0371)	-0.0452 (0.1064)
USD-LC residual maturity difference _t (years)	0.0277 (0.0227)	0.0241 (0.0234)	0.0209 (0.0251)	0.0104 (0.0280)
USD share _t (%)		0.0033 (0.0031)	0.0031 (0.0034)	-0.0046 (0.0066)
Observations	2,027	2,027	1,868	1,228
R-squared	0.6050	0.6053	0.6193	0.7937
Country*Industry*Year FE	✓	✓	✓	✓
Firm FE	-	-	-	✓
Firm-level controls	-	-	✓	✓
No. clusters	49	49	49	37
No. FEs	735	735	687	821

Note: Table 7 report panel regressions results on firms' relative borrowing costs in U.S. dollar versus local currency. Our theory predicts a negative correlation between firms' cash-flow sensitivity to exchange rate, and the spread it pays to borrow in foreign-currency over local currency. We specialize to firm-year observations with both local-currency and dollar-denominated borrowing. The dependent variable, USD-LC spread, is the difference (in percentage points) between dollar interest rate and local-currency interest rate, with the interest rates aggregated using the sizes of each case of borrowing as weights. Columns (1) to (3) reports panel regression results with country-industry-year fixed effect to account for, among other things, expected local currency depreciation. Columns (4) adds firm fixed effect. In each regression, we additionally control for the difference in size-weighted average maturity of the debt issued, and in columns (3) and (4) the set of firm-level controls we employ in the baseline panel regressions (see Table 3). Both the spread and the weighted average maturity are winsorized at 2.5 and 97.5 percentile. Standard errors are clustered at the industry level. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

5 Conclusion

In this paper, we set out to explain the puzzling observation that corporates in emerging market economies, for which borrowing in local currency would provide greater hedging benefits, actually borrow more in foreign currency. We provide an explanation based on an international corporate finance model where firms facing adverse selection choose the composition of the debt structure between local currency and foreign currency to signal their quality to investors. The signalling game in our model has a unique separating equilibrium, in which good firms optimally expose themselves

to currency risk to reveal their type. A distinct feature of our theory is that the co-movement between the firm's cash flows and the foreign currency/local currency exchange rate is key: if the firm's cash flows tend to fall when the foreign currency appreciates, higher foreign currency share of debt signals a good type, *and vice versa*. Our model also provides a rationale for why emerging market firms forgo hedging their currency exposures.

Evidence using panel data analysis and event studies of local currency depreciation episodes provide evidence for the signalling channel in our model. Moreover, another distinct prediction of our model is that a higher foreign currency share predicts higher earnings for firms whose cash flows co-move negatively with the foreign currency (the dollar in our empirical setup), while it predicts lower earnings for firms whose cash flows positively with the foreign currency. We also show evidence in favor of this prediction.

Our model has important implications for assessing vulnerabilities for emerging market firms arising from currency mismatch in the corporate sector. Our findings suggest that in the presence of information asymmetries, good firms signal their quality by exposing themselves to currency risk. As a result, firms that take on this risk are actually better placed to weather foreign currency appreciation shocks. That said, large shocks could nevertheless cause distress. Therefore, our model suggests that reducing information asymmetries would be an important policy tool to mitigate corporate risk taking in emerging market economies. However, our results also suggest that currency mismatches alone need not be a cause for concern as previously thought. Our work could also be extended to measure the relative importance of the signalling channel to all other channels and the aggregate implications arising from this channel and information asymmetries in general.

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A Symmetry Between Expressions for LC and FC shares

Define $\tilde{B} = B\alpha$, $\tilde{\varepsilon} = 1/\varepsilon$, $\tilde{\alpha} = 1/\alpha$. Let also $\tilde{X} = X/\varepsilon$. Then, in these variables, we can re-define everything in foreign currency, and the joint density can be computed using the standard formula

$$\tilde{\eta}(\tilde{x}, \mu, \tilde{\varepsilon}) = \eta(\tilde{x}/\tilde{\varepsilon}, \mu, 1/\tilde{\varepsilon})\tilde{\varepsilon}^{-3}$$

where ε^{-3} is the determinant of the Jacobian of the map $(x/\varepsilon, \mu, 1/\varepsilon) \rightarrow (x, \mu, \varepsilon) = (\tilde{x}/\tilde{\varepsilon}, \mu, 1/\tilde{\varepsilon})$. The first observation is that $(\log \tilde{\eta})_{\mu x}$ has the same sign as $(\log \eta)_{\mu x}$. The second observation is that the conditions of positive association for $\tilde{\varepsilon}$ with \tilde{x} and $\tilde{\mu}$ take the form

$$0 \leq (\log \tilde{\eta})_{\mu \tilde{\varepsilon}} = (\log(\eta(\tilde{x}/\tilde{\varepsilon}, \mu, 1/\tilde{\varepsilon}) - 3 \log \tilde{\varepsilon}))_{\mu \tilde{\varepsilon}} = -\tilde{\varepsilon}^{-2}(\log \eta)_{\mu \varepsilon} - \tilde{x}\tilde{\varepsilon}^{-2}(\log \eta)_{\mu x}$$

whereas

$$\begin{aligned} 0 \leq (\log \tilde{\eta})_{x \tilde{\varepsilon}} &= (\log(\eta(\tilde{x}/\tilde{\varepsilon}, \mu, 1/\tilde{\varepsilon}) - 3 \log \tilde{\varepsilon}))_{x \tilde{\varepsilon}} \\ &= -\tilde{\varepsilon}^{-2}(\log \eta)_{x \varepsilon} - \tilde{x}\tilde{\varepsilon}^{-2}(\log \eta)_{\mu x} - \tilde{x}/\tilde{\varepsilon}^2(\log \eta)_{xx} - \tilde{\varepsilon}^{-3}(\log \eta)_{x \varepsilon}. \end{aligned}$$

Now, total face value is $\bar{B} = B(1 + \alpha\varepsilon) = \tilde{B}\tilde{\alpha}(1 + 1/(\tilde{\alpha}\tilde{\varepsilon})) = \tilde{B}\tilde{\varepsilon}^{-1}(1 + \tilde{\alpha}\tilde{\varepsilon})$ equity value is

$$E[(X - \bar{B})^+] = E[(\tilde{X}/\tilde{\varepsilon} - \tilde{B}\tilde{\varepsilon}^{-1}(1 + \tilde{\alpha}\tilde{\varepsilon}))^+] = E[\tilde{\varepsilon}^{-1}(\tilde{X} - \tilde{B}(1 + \tilde{\alpha}\tilde{\varepsilon}))^+].$$

Similarly,

$$\bar{P}(\alpha) = E[\tilde{\varepsilon}^{-1}(1 + \tilde{\alpha}\tilde{\varepsilon})(1 - \tilde{\Phi}(\tilde{B}(1 + \tilde{\alpha}\tilde{\varepsilon})))]$$

We can define a new expectation with the measure $\tilde{\varepsilon}^{-1}/E[\tilde{\varepsilon}^{-1}]$, and all the formulas remain the same, with I replaced by $I/E[\varepsilon]$.

B Proofs

We will be extensively using the following technical lemma.

Lemma B.1

$$E[f(X)g(X)] \geq E[f(X)] E[g(X)]$$

for any two monotone increasing functions f, g .

The following lemma is a direct consequence of Lemma B.1.

Lemma B.2 *Suppose that we have two random variables X_1, X_2 with probability densities η_1, η_2 such that $\eta_1(x)/\eta_2(x)$ is monotone increasing in x . Then, $E[f(X_1)] \geq E[f(X_2)]$ for any monotone increasing function f .*

Proof of Proposition 3.3. At an interior optimum of

$$\max_{\alpha} E[\Psi(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)],$$

we get that the first order condition defining the candidate optimum $\alpha = A(\mu)$ is given by

$$-E[(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon))(B'(\alpha)(1 + \varepsilon\alpha) + B(\alpha)\varepsilon)] = 0,$$

where $B(\alpha) = I/\bar{P}(\alpha)$ and where

$$\bar{P}(\alpha) = E[(1 + \varepsilon\alpha)(1 - \Phi((1 + \alpha\varepsilon)I/\bar{P}(\alpha), \mu(\alpha), \varepsilon))].$$

Thus, we have

$$B'(\alpha) = -I\bar{P}'(\alpha)\bar{P}(\alpha)^{-2}$$

and hence

$$\begin{aligned} 0 &= -E[(1 - \Phi(I\bar{P}(\alpha)^{-1}(1 + \varepsilon\alpha), \mu, \varepsilon))(-I\bar{P}'(\alpha)\bar{P}(\alpha)^{-2}(1 + \varepsilon\alpha) + I\bar{P}(\alpha)^{-1}\varepsilon)] \\ &= -I\bar{P}'(\alpha)\bar{P}(\alpha)^{-2} \underbrace{E[(1 - \Phi(I\bar{P}(\alpha)^{-1}(1 + \varepsilon\alpha), \mu, \varepsilon))(1 + \varepsilon\alpha)]}_{=\bar{P}(\alpha)} \\ &+ I\bar{P}(\alpha)^{-1}E[(1 - \Phi(I\bar{P}(\alpha)^{-1}(1 + \varepsilon\alpha), \mu, \varepsilon))\varepsilon] \\ &= I\bar{P}(\alpha)^{-1}(-\bar{P}'(\alpha) + E[(1 - \Phi(I\bar{P}(\alpha)^{-1}(1 + \varepsilon\alpha), \mu, \varepsilon))\varepsilon]), \end{aligned}$$

and the claim follows.

Q.E.D.

Proof of Proposition 3.4. We have

$$\mu'(\alpha) = \frac{d}{d\alpha}F = F_x \bar{P}'(\alpha) + F_y.$$

By the implicit function theorem,

$$F_x = \frac{1 - I^{-1}E[(1 + \varepsilon y)I/x]^2 \eta((1 + \varepsilon y)I/x, F, \varepsilon)]}{-E[(1 + \varepsilon y)\Phi_\mu((1 + \varepsilon y)I/x, F, \varepsilon)]}$$

and

$$F_y = \frac{E[\varepsilon((1 - \Phi((1 + \varepsilon y)I/x, F, \varepsilon)) - ((1 + \varepsilon y)I/x)\varepsilon\eta((1 + \varepsilon y)I/x, F, \varepsilon))]}{E[(1 + \varepsilon y)\Phi_\mu((1 + \varepsilon y)I/x, F, \varepsilon)]}$$

By Proposition 3.3, we have

$$\bar{P}'(\alpha) = E[\varepsilon(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha), \mu(\alpha), \varepsilon))].$$

As a result, use the shorthand notation $z = B(\alpha)(1 + \varepsilon(\alpha)) = (1 + \varepsilon(\alpha))I/\bar{P}(\alpha)$, we have

$$\begin{aligned} \mu'(\alpha) &= \frac{E[(1 - I^{-1}z^2\eta(z))]}{-E[(1 + \varepsilon y)\Phi_\mu((1 + \varepsilon y)I/x, F, \varepsilon)]} E[\varepsilon(1 - \Phi(z))] \\ &+ \frac{E[\varepsilon((1 - \Phi(z) - z\eta(z)))]}{E[(1 + \varepsilon y)\Phi_\mu((1 + \varepsilon y)I/x, F, \varepsilon)]} \\ &= \frac{-I^{-1}E[z^2\eta(z)] E[\varepsilon(1 - \Phi(z))] + E[\varepsilon z\eta(z)]}{-E[(1 + \varepsilon y)\Phi_\mu((1 + \varepsilon y)I/x, F, \varepsilon)]}. \end{aligned}$$

Since $\Phi_\mu < 0$, the sign of $\mu'(\alpha)$ coincides with that of

$$\begin{aligned}
\psi(\alpha) &\equiv -I^{-1}E[(I/\bar{P})^2(1+\varepsilon\alpha)^2\eta((I/\bar{P})(1+\varepsilon\alpha))]E[\varepsilon(1-\Phi((I/\bar{P})(1+\varepsilon\alpha)))] \\
&+ E[\varepsilon(I/\bar{P})(1+\varepsilon\alpha)\eta((I/\bar{P})(1+\varepsilon\alpha))] \\
&= I/(\bar{P})^2\left(-E[(1+\varepsilon\alpha)^2\eta((I/\bar{P})(1+\varepsilon\alpha))]E[\varepsilon(1-\Phi((I/\bar{P})(1+\varepsilon\alpha)))]\right. \\
&+ \left.E[\varepsilon(1+\varepsilon\alpha)\eta((I/\bar{P})(1+\varepsilon\alpha))]\bar{P}\right) \\
&= I/(\bar{P})^2\left(-E[(1+\varepsilon\alpha)^2\eta(\kappa(1+\varepsilon\alpha))]E[\varepsilon(1-\Phi(\kappa(1+\varepsilon\alpha)))]\right. \\
&+ \left.E[\varepsilon(1+\varepsilon\alpha)\eta(\kappa(1+\varepsilon\alpha))]E[(1+\varepsilon\alpha)(1-\Phi(\kappa(1+\varepsilon\alpha)))]\right)
\end{aligned} \tag{6}$$

where we denote $\kappa = I/\bar{P}$. Let us change the measure to $(1+\varepsilon\alpha)(1-\Phi(\kappa(1+\varepsilon\alpha)))/E[(1+\varepsilon\alpha)(1-\Phi(\kappa(1+\varepsilon\alpha)))]$, and denote the covariances under this measure as Cov^* . Then, the sign of (6) coincides with that of

$$\text{Cov}^*(\varepsilon/(1+\varepsilon\alpha), (1+\varepsilon\alpha)h(\kappa(1+\varepsilon\alpha)))$$

where we have defined

$$h(x, \mu, \varepsilon) = \frac{\eta(x|\mu, \varepsilon)}{1 - \Phi(x|\mu, \varepsilon)}.$$

Thus, by Lemma B.1, the sign of $\mu'(\alpha)$ is positive (negative) if the function $(1+\varepsilon\alpha)h(\kappa(1+\varepsilon\alpha))$ is monotone increasing (decreasing) in ε . Now,

$$\frac{d}{d\varepsilon}((1+\varepsilon\alpha)h(\kappa(1+\varepsilon\alpha))) = \alpha h + \kappa\alpha(1+\varepsilon\alpha)h_x + (1+\varepsilon\alpha)h_\varepsilon, \tag{7}$$

and h_ε is proportional to $\frac{\eta_\varepsilon}{\eta} - \frac{\int_x^\infty \eta_\varepsilon(y)dy}{\int_x^\infty \eta(y)dy}$, and hence h_ε is positive when $\frac{\eta_\varepsilon}{\eta}$ is decreasing in x . Since η is log-concave, standard properties of log-concave densities imply that $h(x)$ is monotone increasing. Suppose that $(\log \eta)_{\varepsilon x} < 0$ (the case of $(\log \tilde{\eta})_{\varepsilon x} < 0$ is analogous). This is equivalent to $\frac{\eta_\varepsilon}{\eta}$ being monotone decreasing in x . Thus, $h_\varepsilon > 0$ in this case, and hence all three terms in (7) are positive, and therefore (7) is positive.

To prove the last claim (monotonicity of the equity value with respect to μ), we notice that is

easier to study monotonicity with respect to α . We have

$$\frac{d}{d\alpha} E[\Psi((1 + \alpha\varepsilon)I/\bar{P}(\alpha), \mu(\alpha), \varepsilon)] = \mu'(\alpha) E[\Psi_\mu((1 + \alpha\varepsilon)I/\bar{P}(\alpha), \mu(\alpha), \varepsilon)].$$

Here,

$$\Psi_\mu = \int_x^\infty (y - x)\eta_\mu(y|\mu, \varepsilon)dy$$

By assumption, η_μ/η is monotone increasing in y and hence, by Lemma B.1, we have

$$\frac{\int_x^\infty (y - x)\eta_\mu(y|\mu, \varepsilon)dy}{1 - \Phi(x)} \geq \frac{\int_x^\infty (y - x)\eta(y|\mu, \varepsilon)dy}{1 - \Phi(x)} \frac{\int_x^\infty \eta_\mu(y|\mu, \varepsilon)dy}{1 - \Phi(x)}$$

Since $\Phi_\mu \leq 0$, we have $\int_x^\infty \eta_\mu(y|\mu, \varepsilon)dy = -\Phi_\mu \geq 0$. If $\mu(\alpha)$ is increasing in α , then we get the required. If $\mu(\alpha)$ is decreasing in α , then the equity value $E(\alpha) = E[\Psi((1 + \alpha\varepsilon)I/\bar{P}(\alpha), \mu(\alpha), \varepsilon)]$ is decreasing in α and hence $E(\mu) = E(A(\mu))$ is increasing in μ .

Q.E.D.

Lemma B.3 *The following is true:*

- *If $A(\mu)$ is monotone increasing in μ and*

$$\frac{\Phi_\mu(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)}{1 - \Phi(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)}$$

is monotone increasing in ε for all $\alpha \in \mathbb{R}_+$, then $A(\mu)$ is indeed the optimum;

- *If $A(\mu)$ is monotone decreasing in μ and*

$$\frac{\Phi_\mu(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)}{1 - \Phi(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)}$$

is monotone decreasing in ε for all $\alpha \in \mathbb{R}_+$, then $A(\mu)$ is indeed the optimum.

Proof of Lemma B.3. To prove that $\alpha = A(\mu)$ is indeed the maximizer of the equity value, it would suffice to show that the derivative of the equity value is negative for $\alpha < A(\mu)$ and positive

otherwise. That is, it suffices to show that that

$$E[(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon))(B'(\alpha)(1 + \varepsilon\alpha) + B(\alpha)\varepsilon)] < 0 \quad (8)$$

for $\alpha < A(\mu)$ and that the sign flips for $\alpha > A(\mu)$. Equivalently, we can rewrite the optimality condition (8) for $\alpha < A(\mu)$ as

$$\frac{B'(\alpha)}{B(\alpha)} < -\frac{E[\varepsilon(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon)]}{E[(1 + \varepsilon\alpha)(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon)]}, \quad \alpha < A(\mu). \quad (9)$$

The proof for the case $\alpha > A(\mu)$ is analogous. Suppose first that $A(\mu)$ is monotone increasing in μ . Then, we need to show (9) for $\mu > \mu(\alpha)$. Since (9) holds with equality for $\mu = \mu(\alpha)$, it would be sufficient to show that the function $\frac{E[\varepsilon(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon)]}{E[(1 + \varepsilon\alpha)(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon)]}$ is monotone decreasing in μ . Differentiating this function with respect to μ , we get that we need the inequality

$$\begin{aligned} & -E[\varepsilon\Phi_\mu(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)]E[(1 + \varepsilon\alpha)(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon)] \\ & + E[\varepsilon(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon)]E[(1 + \varepsilon\alpha)\Phi_\mu(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)] \leq 0, \end{aligned}$$

which is equivalent to

$$\begin{aligned} & -E[\varepsilon\Phi_\mu(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)]E[(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon)] \\ & + E[\varepsilon(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon)]E[\Phi_\mu(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)] \leq 0, \end{aligned}$$

Changing the density to $(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon)/E[(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon)]$, and denoting expectations under this density with E^* , we can rewrite the desired inequality as

$$-\text{Cov}^*\left[\varepsilon, \frac{\Phi_\mu(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)}{1 - \Phi(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)}\right] \leq 0,$$

which follows from Lemma B.1 and the assumption that $\frac{\Phi_\mu(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)}{1 - \Phi(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)}$ is monotone increasing in ε .

By contrast, if $A(\mu)$ is decreasing, then we need that $\frac{E[\varepsilon(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon)]}{E[(1 + \varepsilon\alpha)(1 - \Phi(B(\alpha)(1 + \varepsilon\alpha)), \mu, \varepsilon)]}$ be monotone

increasing in μ . This is in turn equivalent to the inequality

$$-\text{Cov}^*[\varepsilon, \frac{\Phi_\mu(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)}{1 - \Phi(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)}] \geq 0,$$

which follows from Lemma B.1 under the assumption that $\frac{\Phi_\mu(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)}{1 - \Phi(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon)}$ is monotone decreasing in ε .

Q.E.D.

Lemma B.4 *We always have that*

$$\frac{\Phi_\mu(x, \mu, \varepsilon)}{1 - \Phi(x, \mu, \varepsilon)}$$

is monotone decreasing in x . If $(\log \eta)_{x\varepsilon} \geq 0$ and $(\log \eta)_{\mu\varepsilon} \geq 0$, then

$$\frac{\Phi_\mu(x, \mu, \varepsilon)}{1 - \Phi(x, \mu, \varepsilon)}$$

is monotone decreasing in ε and

$$\frac{\Phi_\mu(b + a\varepsilon, \mu, \varepsilon)}{1 - \Phi(b + a\varepsilon, \mu, \varepsilon)}$$

is monotone decreasing in ε for any $a \geq 0$.

Proof of Lemma B.4. Since $\int_{\mathbb{R}} \eta(x|\mu, \varepsilon) dx = 1$, we have $\int_{\mathbb{R}} \eta_\mu(x|\mu, \varepsilon) dx = 0$, and hence

$$\frac{\Phi_\mu(x, \mu, \varepsilon)}{1 - \Phi(x, \mu, \varepsilon)} = \frac{-\int_x^\infty \eta_\mu(y|\mu, \varepsilon) dy}{\int_x^\infty \eta(y|\mu, \varepsilon) dy}$$

Differentiating with respect to x , we get that the required monotonicity is equivalent to

$$\frac{\eta_\mu(x|\mu, \varepsilon)}{\eta(x|\mu, \varepsilon)} \leq \frac{\int_x^\infty \eta_\mu(y|\mu, \varepsilon) dy}{\int_x^\infty \eta(y|\mu, \varepsilon) dy},$$

which follows directly from the assumed monotonicity of $\frac{\eta_\mu(x|\mu, \varepsilon)}{\eta(x|\mu, \varepsilon)}$.

Now, differentiating this quotient with respect to ε , we get that the sign of this derivative

coincides with that of

$$-\int_x^\infty \eta_{\mu\varepsilon}(y|\mu, \varepsilon)dy \int_x^\infty \eta(y|\mu, \varepsilon)dy + \int_x^\infty \eta_\mu(y|\mu, \varepsilon)dy \int_x^\infty \eta_\varepsilon(y|\mu, \varepsilon)dy.$$

Introducing the conditional probability measure $\mathbf{1}_{y \geq x} \eta(y|\mu, \varepsilon) / \int_x^\infty \eta(y|\mu, \varepsilon)dy$, we can rewrite the quantity of interest as

$$-E[\eta_{\mu\varepsilon}(X|\mu, \varepsilon)/\eta] + E[\eta_\varepsilon/\eta] E[\eta_\mu/\eta].$$

Suppose first $(\log \eta)_{\varepsilon x} \geq 0$ and $(\log \eta)_{\mu\varepsilon} \geq 0$. Then,

$$\eta_{\mu\varepsilon} \geq \frac{\eta_\varepsilon \eta_\mu}{\eta}$$

and hence, by Lemma B.1,

$$E[\eta_{\mu\varepsilon}(X|\mu, \varepsilon)/\eta] \geq E[(\eta_\varepsilon/\eta)(\eta_\mu/\eta)] \geq E[\eta_\varepsilon/\eta] E[\eta_\mu/\eta].$$

Q.E.D.

Proof of Proposition 3.6. We only consider the case of negative association between x, μ, ε . The opposite case is analogous.

Suppose that $(\log \eta)_{\varepsilon x} < 0$. Let $\mu(\alpha)$ be a candidate equilibrium. By Proposition 3.4, it is monotone increasing in α , and hence $A(\mu)$ is also monotone increasing in α .

By assumption, $(\log \tilde{\eta})_{\tilde{x}\tilde{\varepsilon}} \geq 0$ and $(\log \tilde{\eta})_{\mu\tilde{\varepsilon}} \geq 0$. Therefore, Lemma B.4 implies that

$$\frac{\tilde{\Phi}_\mu(b + a\tilde{\varepsilon}, \mu, \tilde{\varepsilon})}{1 - \tilde{\Phi}(b + a\tilde{\varepsilon}, \mu, \tilde{\varepsilon})}$$

is monotone decreasing in $\tilde{\varepsilon}$ for any $a \geq 0$.

Let $\tilde{A}(\mu) = 1/A(\mu)$. Then, $\tilde{A}(\mu)$ is monotone decreasing in μ and the second item of Lemma B.3 implies that $\tilde{A}(\mu)$ is the interior optimum for firm value maximization over $\tilde{\alpha} = 1/\alpha$. The proof is complete.

Q.E.D.

Proof of Proposition 3.7. We have

$$\begin{aligned} \frac{\partial}{\partial \varepsilon} \Psi(B(\alpha)(1 + \varepsilon\alpha), \mu, \varepsilon) &= \frac{\partial}{\partial \varepsilon} \int_{B(\alpha)(1 + \varepsilon\alpha)}^{\infty} (y - x)\eta(y|\mu, \varepsilon) dy \\ &= \int_{B(\alpha)(1 + \varepsilon\alpha)}^{\infty} (y - x) \frac{\partial}{\partial \varepsilon} \eta(y|\mu, \varepsilon) dy \end{aligned}$$

where we have defined

$$x = B(\alpha)(1 + \varepsilon\alpha)$$

By the monotone likelihood property this beta will be positive if ε, y are positively related, and negative otherwise. Q.E.D.

Proof of Proposition 4.1. If $(\log \eta)_{x\varepsilon} < 0$, the variables are negatively associated and $E[\mathbf{1}_{(1+\alpha\varepsilon)I/\bar{P}(\alpha) < x} | \varepsilon]$ is monotone decreasing in ε , so that

$$\begin{aligned} P_{\S}(\alpha) &= E[\varepsilon E[\mathbf{1}_{(1+\alpha\varepsilon)I/\bar{P}(\alpha) < x} | \varepsilon]] \\ &\leq E[\varepsilon] E[\mathbf{1}_{(1+\alpha\varepsilon)I/\bar{P}(\alpha) < x}] = E[\varepsilon] P(\alpha) \end{aligned}$$

The opposite case of a negative association between \tilde{x} and $\tilde{\varepsilon}$ is analogous. For the dependence on β , define $f(\beta) = P_{\S}(\alpha) - E[\varepsilon]P(\alpha)$. By real analyticity, for generic parameters, $f'(0) \neq 0$, and the inequality above implies that $f'(0) > 0$, implying the required monotonicity. Q.E.D.

C Data appendix, additional tables from empirical analysis

C.1 More details on data

Capital IQ We download Capital IQ data covering main financial statements and debt capital structure of firms. Emerging market economies that have adopted a fully pegged or strongly managed exchange rate regime in our sample period (2005-2021) are dropped. This include China, Morocco, Kuwait, Saudi Arabia and Romania. We drop firms in the financial sector (two-digit SIC code from 60 to 69). We also require that the firms included in our regressions have outstanding debt on their balance sheet.

Merge Capital IQ data with Worldscope We download, from Wharton Research Data Services (WRDS), the crosswalk between Capital IQ’s unique identifier (`companyid`) to firms’ International Securities Identification Number (ISIN). We further use Worldscope monthly stock price dataset to link the ISIN numbers to Worldscope’s unique permanent ID. After the merge, over 50% of the 2005-2021 CapitalIQ data have non-missing values on stock prices. Due to multi-listing, one `companyid` may correspond to multiple ISINs. For consistency, we use price information on local-listed stocks whenever possible by utilizing information from Worldscope’s dataset on listed exchanges. For foreign-listed firms, we compute their stock return-depreciation β s by first transforming the stock prices to local currency of their headquarters, also to ensure consistency. We make sure to avoid look-ahead bias by using the stock price recorded at the end of the companies’ year end when computing market caps and merging with Capital IQ financial data.

C.2 Additional robustness checks, tables and figures

This section reports a set of extensive robustness checks on our empirical results in Section 4. Table C1 repeats the full-panel analysis reported in Table 3, but with firm-year observations with β insignificantly larger than zero excluded. Table C2 use firm-level EBITDA in year $t + 1$ as the dependent variable (for consistency, we accordingly control for current level of EBITDA in the information set at year t). To alleviate the concern on potential inconsistencies between total debt reported in the main financial statements provided by Capital IQ and total debt aggregated from

the capital structure module, we report in Table C3 robustness checks excluding observations with large deviations between the bottom-up figures and the main statement figures. Table C4 repeats the exercise of Table 6 investigating the different predictive relationship between positive- β and negative- β firms, but redefine the positive- β firm-year observations to include those with $\beta > 0$, but insignificantly larger than zero at 5% significance level. Table C5 explores a larger sample (all firms, including those who have never borrowed in foreign currencies) in Panel (a) and alternative clustered standard errors in Panel (b). Finally, Table C6 restricts the sample to years of major stress episodes including the Great Financial Crisis (2007-08), EM-wide currency stress (2014-15), and the COVID-19 crisis (2019-20).

As an additional validation of our model, we also show in Figure C1 that the model is able to generate a monotonically increasing relationship between cash flow (shareholder value) volatility and foreign-currency share in borrowing, consistent with the aggregate pattern (Figure 1(b)).

Table C1: Signaling channel of foreign-currency debt: Full panel, negative- β sample

Panel (a): Levels of foreign-currency share

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic and pos. fc $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\log(\text{capex})_{f,t+1}$
foreign currency share $_{f,t}$ (%)	0.006*** (0.002)			0.008** (0.003)	0.006*** (0.002)	0.004* (0.003)	0.0004*
hard currency share $_{f,t}$ (%)		0.007*** (0.002)					
fc share $_{f,t}$ (bank loan, %)			0.004** (0.002)				
Observations	44,253	44,253	42,594	13,865	40,884	20,830	43,721
R-squared	0.720	0.720	0.716	0.771	0.713	0.756	0.8997
Firm-level controls	✓	✓	✓	✓	✓	✓	✓
Country*Industry*Year*Quarter FE	✓	✓	✓	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓	✓	✓	✓
No. clusters	63	63	63	46	63	59	63
No. FEs	11141	11141	10834	4897	10325	7134	11076

Panel (b): Changes in foreign-currency share

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic and pos. fc $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic and pos. fc $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\log(\text{capex})_{f,t+1}$
Δ foreign currency share $_{f,t-1,t}$ (%)	0.005*** (0.001)			0.003 (0.003)	0.005*** (0.001)	0.003* (0.002)	0.0004** (0.0002)
Δ hard currency share $_{f,t-1,t}$ (%)		0.006*** (0.002)					
Δ fc share $_{f,t-1,t}$ (bank loan, %)			0.004*** (0.001)				
Observations	43,115	43,115	40,735	13,563	39,803	20,256	42,593
R-squared	0.722	0.722	0.718	0.771	0.715	0.759	0.9013
Firm-level controls	✓	✓	✓	✓	✓	✓	✓
Country*Industry*Year*Quarter FE	✓	✓	✓	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓	✓	✓	✓
No. clusters	63	63	63	46	63	59	63
No. FEs	11035	11035	10584	4833	10225	7034	10972

Note: Table C1 reports panel regressions relating foreign currency share of outstanding debt to future earnings. The dependent variable is EBIT divided by total assets in the year $t + 1$, expressed as percentages. All independent variables are sampled at year t . The sample period is 2005 to 2021. Our baseline samples are firms with at least one year of positive foreign-currency borrowing in the data. We also require these firms to have a negative rolling β coefficient estimated using a regression of overlapping quarterly stock returns on local currency depreciation at monthly frequency. Different from Table 3, firm-year observations with β insignificantly larger than zero are excluded. Firms' financial variables are winsorized at 2.5 and 97.5 percentile. Panel (a) use levels of foreign-currency shares as the key predictor, and Panel (b) explores the relationship between earnings, investment and changes in foreign-currency shares. In each panel, Column (1) focuses on all firms in our baseline sample and our baseline foreign-currency share measure containing all currencies and all types of borrowing. In column (2) and (3), the key independent variable is hard-currency share (share of CHF, EUR, GBP, JPY and USD) and share of foreign-currency bank loans (term loans and credit lines), respectively. Column (4) restricts the sample to non-tradable firms (Aguar and Gopinath, 2005). Column (5) looks at domestic firms only, defined as firms not listed overseas, and those that do not have an overseas ultimate parent. Column (6) further restricts the domestic-firm sample to observations with positive foreign-currency debt outstanding. In column (7), the dependent variable is log capex. Standard errors are clustered at the industry level. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Table C2: Signaling channel of foreign-currency debt (levels): Full panel, EBITDA

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)
	$\frac{EBITDA_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBITDA_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBITDA_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable $\frac{EBITDA_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic $\frac{EBITDA_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic and pos. fc $\frac{EBITDA_{f,t+1}}{Asset_{f,t+1}}$ (%)
foreign currency share _{f,t} (%)	0.005*** (0.002)			0.007** (0.003)	0.005** (0.002)	0.003 (0.002)
hard currency share _{f,t} (%)		0.006*** (0.002)				
fc share _{f,t} (bank loan, %)			0.004** (0.001)			
EBITDA/Total Assets (%)	0.381*** (0.013)	0.381*** (0.013)	0.382*** (0.015)	0.361*** (0.025)	0.383*** (0.014)	0.316*** (0.020)
yoy stock return _{f,t}	0.006*** (0.001)	0.006*** (0.001)	0.006*** (0.001)	0.008*** (0.002)	0.006*** (0.001)	0.007*** (0.001)
current ratio _{f,t}	-0.415*** (0.042)	-0.415*** (0.042)	-0.444*** (0.049)	-0.280*** (0.074)	-0.404*** (0.044)	-0.378*** (0.109)
z-score _{f,t}	0.002 (0.042)	0.002 (0.042)	-0.015 (0.044)	-0.016 (0.069)	-0.016 (0.038)	-0.078 (0.055)
log capex _{f,t}	0.010 (0.038)	0.010 (0.038)	0.033 (0.041)	-0.021 (0.069)	0.016 (0.038)	-0.059 (0.079)
log total liabilities _{f,t}	-0.651*** (0.128)	-0.649*** (0.127)	-0.709*** (0.121)	-0.185 (0.315)	-0.661*** (0.123)	-0.663*** (0.144)
log market cap _{f,t}	0.287*** (0.094)	0.287*** (0.094)	0.291*** (0.090)	0.329* (0.183)	0.339*** (0.098)	0.378*** (0.125)
rolling $\beta_{f,t}$	0.031 (0.029)	0.031 (0.029)	0.024 (0.026)	0.086 (0.069)	0.033 (0.028)	0.046 (0.052)
Observations	48,091	48,091	46,180	15,199	44,329	22,549
R-squared	0.740	0.740	0.736	0.797	0.734	0.770
Country*Industry*Year*Quarter FE	✓	✓	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓	✓	✓
No. clusters	63	63	63	47	63	59
No. FEs	11885	11885	11560	5279	10999	7608

Note: Table C2 reports panel regressions relating foreign currency share of outstanding debt to future earnings. The dependent variable is EBITDA divided by total assets in the year $t + 1$, expressed as percentages. All independent variables are sampled at year t . The sample period is 2005 to 2021. Our baseline samples are firms with at least one year of positive foreign-currency borrowing in the data. We also require these firms to have a negative rolling β coefficient estimated using a regression of overlapping quarterly stock returns on local currency depreciation at monthly frequency. Column (1) focuses on all firms in our baseline sample and our baseline foreign-currency share measure containing all currencies and all types of borrowing. In column (2) and (3), the key independent variable is hard-currency share (share of CHF, EUR, GBP, JPY and USD) and share of foreign-currency bank loans (term loans and credit lines), respectively. Column (4) restricts the sample to non-tradable firms (Aguiar and Gopinath, 2005). Column (5) looks at domestic firms only, defined as firms not listed overseas, and those that do not have an overseas ultimate parent. Column (6) further restricts the domestic-firm sample to observations with positive foreign-currency debt outstanding. Standard errors are clustered at the industry level. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Table C3: Consistency check: Full panel analysis, removing observations with debt structure inconsistent with aggregate figures

Panel (a): Levels of foreign-currency share

VARIABLES	(1)	(2)	(3)	(4)
	25%	10%	5%	1%
	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)
foreign currency share $_{f,t}$ (%)	0.006** (0.002)	0.006*** (0.002)	0.006*** (0.002)	0.006** (0.002)
Observations	44,801	42,124	40,051	34,698
R-squared	0.723	0.727	0.729	0.742
Firm-level controls	✓	✓	✓	✓
Country*Industry*Year*Quarter FE	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓
No. clusters	63	63	63	62
No. FEs	11520	11204	10919	10027

Panel (b): Changes in foreign-currency share

VARIABLES	(1)	(2)	(3)	(4)
	25%	10%	5%	1%
	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)
Δ foreign currency share $_{f,t-1,t}$ (%)	0.003** (0.001)	0.003** (0.001)	0.003** (0.001)	0.002 (0.001)
Observations	43,623	41,004	38,947	33,737
R-squared	0.725	0.729	0.731	0.743
Firm-level controls	✓	✓	✓	✓
Country*Industry*Year*Quarter FE	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓
No. clusters	63	63	63	62
No. FEs	11401	11090	10789	9893

Note: Table C3 repeats the exercise of Table 3, column (1), but restricts the sample further to firm-year observations with small deviations between total debt reported on the main balance sheets (CapitalIQ entry 4173), and total outstanding debt aggregated from the security-level capital structure module. From column (1) to column (4) in each panel, we progressively drop observations whose deviations (absolute values normalized by the bottom-up aggregates) are larger than 25%, 10%, 5% and 1%. Standard errors are clustered at the industry level. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Table C4: Signaling channel of foreign-currency debt: The role of stock-depreciation β (alternative definition of positive- β)

VARIABLES	(1) $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	(2) $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	(3) $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	(4) $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	(5) $\log(\text{capex})_{f,t+1}$	(6) $\log(\text{capex})_{f,t+1}$
$\beta_{f,t} > 0$	0.256 (0.271)	0.221 (0.266)	0.282 (0.259)	0.217 (0.265)	-0.0505 (0.0425)	-0.0516 (0.0338)
foreign currency share $_{f,t}$ (%)	0.007*** (0.002)				0.0003 (0.0002)	
FC share $\times (\beta_{f,t} > 0)$	-0.001 (0.005)				-0.0001 (0.0006)	
Δ foreign currency share $_{f,t-1,t}$ (%)		0.005*** (0.001)				0.0005** (0.0002)
Δ FC share $\times (\beta_{f,t} > 0)$		-0.011** (0.005)				-0.0008 (0.0007)
hard currency share $_{f,t}$ (%)			0.007*** (0.002)			
hard currency share $\times (\beta_{f,t} > 0)$			-0.003 (0.006)			
Δ hard currency share $_{f,t-1,t}$ (%)				0.005*** (0.002)		
Δ hard currency share $\times (\beta_{f,t} > 0)$				-0.008 (0.006)		
Observations	48,668	47,414	48,668	47,414	48,082	46,842
R-squared	0.717	0.719	0.717	0.719	0.8996	0.9012
Country*Industry*Year*Quarter FE	✓	✓	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓	✓	✓
Firm-level controls	✓	✓	✓	✓	✓	✓
No. clusters	63	63	63	63	63	63
No. FEs	12026	11917	12026	11917	11955	11849

Note: Table C4 reports panel regression output relating firms' future earnings to foreign-currency share of borrowings, separating firms with positive stock return-depreciation β s from those with negative β s. Compared to Table 6, the positive β firm-year observations include those with an estimated stock return-depreciation β larger than zero yet statistically insignificant at 5% level. The dependent variable (columns (1) to (4)) is EBIT divided by total assets in the year $t + 1$, expressed as percentages, and log capex (columns (5) to (6)). All independent variables are sampled at year t . The sample period is 2005 to 2021. In addition to foreign-currency shares, we interact (changes in) foreign-currency share with a dummy indicating whether firm f has a positive rolling β at year t . Firms' financial variables are winsorized at 2.5 and 97.5 percentile. Columns (1) to (4) use foreign-currency share, changes in foreign-currency share, hard-currency share (CHF, GBP, EUR JPY, USD) and changes in hard-currency share as the key predictor. Columns (5) and (6) focus on the predictive relationship between the overall foreign-currency share and log capex. Standard errors are clustered at the industry level. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Table C5: Panel regressions, alternative samples / clusters

Panel (a): All firms, including those that never borrow in FC

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic and pos. fc $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\log(\text{capex})_{f,t+1}$
foreign currency share _{f,t} (%)	0.007*** (0.002)			0.010*** (0.003)	0.006*** (0.002)	0.004* (0.002)	0.0005** (0.0002)
hard currency share _{f,t} (%)		0.007*** (0.002)					
fc share _{f,t} (bank loan, %)			0.005** (0.002)				
Observations	74,882	74,882	70,614	26,249	69,907	22,566	73,626
R-squared	0.706	0.706	0.703	0.737	0.700	0.751	0.8878
Country*Industry*Year*Quarter FE	✓	✓	✓	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓	✓	✓	✓
No. clusters	63	63	63	52	63	59	63
No. FEs	16978	16978	16320	8108	15787	7609	16822

Panel (b): Alternative clusters for standard error computation

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)
	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	domestic $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)
foreign currency share _{f,t} (%)	0.006*** (0.002)	0.010** (0.004)	0.006** (0.002)	0.006*** (0.002)	0.010** (0.004)	0.006*** (0.002)
Observations	48,139	15,213	44,367	48,139	15,213	44,367
R-squared	0.717	0.764	0.710	0.717	0.764	0.710
Country*Industry*Year*Quarter FE	✓	✓	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓	✓	✓
Cluster	Industry Year	Industry Year	Industry Year	Firm Year	Firm Year	Firm Year
No. clusters	16	16	16	16	16	16
No. FEs	11891	5282	11002	11891	5282	11002

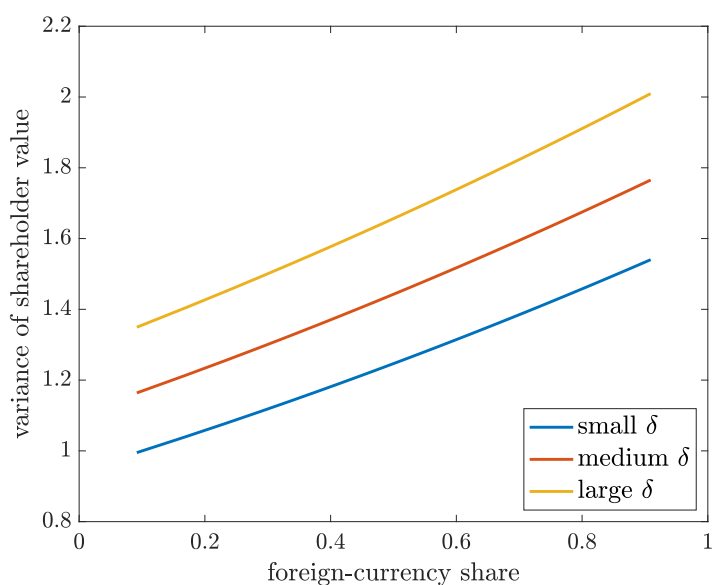
Note: Table C5, Panel (a) repeats the exercise of Table 3, Panel (a), using a larger sample than the baseline, including firms that have never borrowed in foreign currencies throughout our sample. Standard errors are clustered at the industry level. Panel (b) use the baseline sample, but computes standard errors using alternative clusters. In particular, in columns (1) to (3), standard errors are clustered at industry and year level. In columns (4) to (6), standard errors are clustered at firm and year level. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Table C6: Signaling channel during major events: GFC, EM crisis and COVID

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)
	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable & pos fc $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	$\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)	nontradable & pos hc $\frac{EBIT_{f,t+1}}{Asset_{f,t+1}}$ (%)
foreign currency share $_{f,t}$ (%)	0.008* (0.004)	0.020** (0.009)	0.028** (0.012)			
hard currency share $_{f,t}$ (%)				0.008* (0.004)	0.016 (0.010)	0.027* (0.014)
Observations	7,963	2,424	950	7,963	2,424	705
R-squared	0.801	0.860	0.881	0.801	0.860	0.886
Country*Industry*Year*Quarter FE	✓	✓	✓	✓	✓	✓
Firm FE	✓	✓	✓	✓	✓	✓
Firm-level controls	✓	✓	✓	✓	✓	✓
No. clusters	60	42	32	60	42	30
No. FEs	4333	1609	714	4333	1609	538

Note: Table C6 repeats the exercise of Table 3, Panel (a). The samples are further restricted, such that the year $t + 1$ reflect major stress episodes including the Great Financial Crisis (2008), EM-wide currency depreciation (2015), and the COVID-19 period (2020). Columns (1) to (3) uses the level of overall foreign-currency share in year t as the key predictor, while columns (4) to (6) use the level of hard-currency share (CHF, EUR, GBP, JPY, USD). Standard errors are clustered at the industry level. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Figure C1: Model-implied relationship between foreign-currency share and stock market volatility



Note: This figure plots firms' shareholder value volatility as a function of foreign-currency share of borrowing, as implied by the theoretical model in Section 3. We focus on an increasing equilibrium and assume cash flows are conditionally log-normal with parameters $(\mu_\varepsilon, \sigma_\varepsilon)$: $\eta(x|\mu, \varepsilon) = \frac{1}{\sqrt{2\pi}\sigma x} e^{-(\log x - f(\mu, \varepsilon))^2 / (2\sigma^2)}$, with the conditional mean function given by $f(\mu, \varepsilon) = \mu - \delta \log(\varepsilon)$, $\delta \in [5, 6]$. A higher δ corresponds to a more negative $(\log \eta)_{x\varepsilon}$, and thus a larger sensitivity of cash flow to local currency depreciation. The unconditional distribution of the exchange rate is also assumed to be log-normal. Foreign-currency share is expressed as a fraction by transforming the face value ratio α using the transformation $(\alpha^{-1} + 1)^{-1}$. Parameter values are given by: $\varepsilon_* = e^{-0.25}$, $\varepsilon^* = e^{0.25}$, $\mu_\varepsilon = 0.5$, $\sigma_\varepsilon = 0.5$, $\sigma = 0.1$, $I = 0.5$.