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What makes firms manage FX risk?

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Abstract

We examine factors that determine firms' decision to manage foreign exchange risk in an emerging market. Using survey data on the FX risk management of 223 non-financial firms in Korea, we find that firm size, a proxy for hedging costs, is the dominant factor. Consistent with this finding, firm size has stronger explanatory power for external methods than for internal methods, which have relatively lower costs. Besides firm size, export revenue is important in determining the hedging. This is particularly so for public firms, which are subject to disclosure requirements, and thus have more incentive for a stable net income stream.

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1. Introduction

Most of the papers that study the determinants of FX risk management investigate US firms. These include *Géczy et al. (1997)*, which studies 372 Fortune 500 non-financial firms in 1990, and *Howton and Perfect (1998)*, which examines 451 Fortune 500/S&P 500

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non-financial firms in 1994.² There are papers investigating firms outside the US, but they still cover firms from mature economies.³ One exception is Marshall (2000), which includes Asia Pacific multinational companies in his sample. Nevertheless, the paper studies only a limited number of emerging-market firms and provides only summary statistics with no sophisticated analyses.⁴

This paper is motivated to fill the gap in the literature. We focus on firms from an emerging economy. Specifically, we study 223 Korean firms in 2002, relying on survey data compiled by the Korean Financial Supervisory Service (hereafter “FSS”).⁵

There are a number of reasons why firms in emerging economies might behave differently from those in mature economies. One possible source of heterogeneity could be the exchange rate regime the country is subject to. If the country is under a regime where the exchange rate with its major trading partner is kept stable through active FX market intervention, there will not be much of a need to hedge, and thus FX risk management may not be influenced by the factors identified from theory. Since there is not much of a “benefit” to hedge, the “cost” of hedging can become a dominant factor.

Another source of asymmetry could be the underdeveloped FX derivatives market. Instead of using costly derivatives, firms in such countries may rely more on internal hedging methods, such as leading and lagging or pricing policy. Experiencing a currency crisis can also be a source of difference. For firms from emerging economies that have experienced a currency crisis, such as Korea, Thailand, and Indonesia, a sharp depreciation in the local currency may be a source of greater concern than its sudden appreciation. Thus, the fraction of foreign currency-denominated debt might be a more important factor than the proportion of export revenues in explaining the firm’s decision to hedge.

Our main empirical results can be summarized as follows. First, as expected, we find that the cost of hedging is the dominant determinant in a firm’s decision to hedge foreign exchange risk. The coefficient on firm size, our proxy for the cost of hedging or economies of scale, is statistically significant and economically meaningful regardless of the regression specification we use. One possible explanation for this is the stable won–dollar exchange rate maintained since the currency crisis of 1997/98, which discouraged firms from hedging despite their large foreign currency exposures.⁶ Only large firms that could afford the cost were likely to have engaged in hedging.

Second, we find that firm size plays a weaker role when explaining the usage of internal hedging instruments. The coefficient on firm size is statistically insignificant when

² Others include Brown (2001), Allayannis and Ofek (2001), Guay and Kothari (2003), and Martin and Mauer (2004).

³ These studies include Joseph (2000) on UK firms and Hagelin (2000) on Swedish firms.

⁴ In his paper, Asia Pacific MNCs include 20 Australian firms, 30 Hong Kong firms, 100 Japanese firms, 40 Singaporean firms, and 10 Korean firms.

⁵ There are, however, papers in local languages. Yi (2003), for example, studies the use of derivatives by Korean firms during 1999–2001 and finds out that three factors are important when making decisions to use foreign exchange derivatives: export revenue, transaction loss, and translation loss. However, he analyzes only 84 firms each year. He also does not study the impact of firm size, the factor which our study found to be the most important. He includes sales in his regressions, but scales them by asset size, thus making his measure of firm size very different in nature from ours.

⁶ For empirical evidence on the return to the dollar peg, see Mckinnon and Schnabl (2004).

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