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Foreign exchange risk management by Swedish and Korean nonfinancial firms: A comparative survey

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Abstract

This study compares the hedging practices of Swedish and Korean nonfinancial firms. Our findings suggest that the aim of hedging differed between firms in the two countries. Korean firms mostly focused on reducing fluctuations in cash flows, while Swedish firms more commonly emphasized reducing fluctuations of accounting numbers. The proportion of firms that used derivatives was significantly lower in the Korean than in the Swedish sample, a finding that may stem from the relative immaturity of the Korean derivatives markets. The evidence suggests that Korean firms hedged as much as Swedish firms but substituted foreign debt for derivatives. Furthermore, Korean firms appeared to be less rigorous than Swedish firms in overseeing risk management activity. Finally, a large proportion of firms in both countries used a profit-based approach to evaluating the risk management function.

JEL classification: F23; F31
Keywords: Hedging; Foreign exchange exposure; Risk management

1. Introduction

This paper uses survey evidence to compare Swedish and Korean firms' foreign exchange risk management practices. This is of interest because, as Lel's (2003) findings suggest, country-level and internal corporate governance structures and a country's degree of financial market development influence the hedging decisions of corporations. Notably,

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La Porta et al. (1998) reported that Korea lags Sweden in terms of law enforcement, antidirector rights, cash-flow rights, and accounting standards. These differences may cause Korean and Swedish firms to adopt different hedging policies and practices; by studying these, we may improve our understanding of firms' risk management practices.

Several methods are available for managing foreign exchange exposure, including the use of financial derivatives such as forward contracts and currency options, foreign-denominated debt, and internal methods such as leading and lagging. Prior survey evidence pertaining to hedging primarily focused on the use of derivatives by firms in local markets,[1] while a few studies, notably those of Berkman et al. (1997), Alkebäck and Hagelin (1999), Bodnar and Gebhardt (1999), Sheedy (2001), and Bodnar et al. (2003), also compared derivatives use between countries. Recent studies have presented survey evidence pertaining to other hedging techniques, such as the use of foreign-denominated debt and internal hedging techniques. Such studies include those of Hakkarainen et al. (1998), who surveyed Finnish firms; Joseph (2000), who analyzed British firms; Marshall (2000), who analyzed regional differences between Asia-Pacific and Western multinational corporations (MNCs); and Allayannis et al. (2003), who investigated the hedging practices of East Asian firms during the recent East Asian financial crisis.

This paper adds to existing research by analyzing country differences in foreign exchange risk-management practices between Swedish and Korean firms. The focus is on descriptive data comparing hedging practices; these data are complemented by direct tests in order to investigate the potential of firm characteristics to explain differences. Korea and Sweden are both export-oriented countries, heavily dependent on foreign trade, suggesting that their markets would be suitable for this type of study. The countries' markets differ in other ways, such as their stage of economic and financial development. While Swedish derivatives markets are well developed, comparable Korean markets have been heavily regulated until very recently; this may have reduced firms access to, and consequently, knowledge of derivative instruments.

Use of derivatives and other hedging techniques are investigated, using survey evidence pertaining to the foreign exchange exposure and hedging practices of 163 firms in the two countries that replied to a survey distributed in September 2000. In contrast to Marshall (2000), who investigated only large multinational corporations, we sent our survey to all nonfinancial firms listed on the major stock exchange in each country. In view of the findings of Lel (2003) and Bartram et al. (2003), this is an important difference. Lel (2003) investigated large, international firms listed via ADRs in the US and found that country-specific factors were relatively more important than firm-specific factors in explaining the probability of hedging. Bartram et al. (2003) used a larger sample including smaller firms and found that firm-specific factors were relatively more important than country-specific factors. The survey procedure used in our research produced a representative sample of both large and small firms in Korea and Sweden, which may enhance our general understanding of firms' hedging practices.

Our findings suggest that while there are similarities between the hedging practices of firms in the two countries, there are notable differences as well. Firms in both countries

[1] See Batten et al. (1993), Nance et al. (1993), Bodnar et al. (1996, 1998), Berkman et al. (1997), and Alkebäck et al. (2004).