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Multinational corporations and hedging exchange rate exposure

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Abstract

Empirical research measuring multinational corporations' exchange rate exposure is inconclusive. Findings of no significant exposure in some samples and significant exposure in others may be due to offsetting effects for multinational corporations, financial hedging strategies, or simply noisy data. Significant exposure has been found in certain industries and for some smaller firms. This study measures the net exposure to exchange rate changes for a broad cross section of large, US multinational corporations. Using data on financial hedging activity for 276 US multinational corporations, this paper provides evidence that previous findings of no significant exchange rate exposure for this cross section of the economy are likely due in part to the financial hedging activities of these firms. © 2002 Elsevier Science Inc. All rights reserved.

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1. Introduction

In the 1997 edition of *The Annual*, the financial statement publication of McDonald's, Chairman and Chief Executive Officer Mike Quinlan explicitly warns McDonald's investors of the potential impact of changes in currency exchange rates on company profits. He writes,

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"We expect net income per common share growth in the range of 10 to 15 percent in each of the next five years, excluding foreign currency translation."[1] Despite such warnings, many empirical studies of exchange rate movements and stock returns conclude that fluctuations in exchange rates have no significant impact on the return to investors for most corporations, especially for large US multinationals such as McDonald's.

One possible explanation for this insignificant impact is that exchange rates affect the rate of return on a multinational firm's stock through many channels that naturally offset each other. A second explanation is that firms use financial hedging strategies to mitigate losses due to the translation of foreign currency profits and assets into domestic currency prices. Using the recently required reporting of firms' use of foreign currency derivatives (FCDs), this paper seeks to identify the extent to which this hedging activity mitigates foreign currency exposure. Prior to 1990, very little data indicating the firm's foreign currency hedging activities were available. Beginning in June of 1990, firms that issue stock in the US were required to report their use of FCDs.[2] For example, in 1997, McDonald's reported a combined notional amount of foreign currency exchange agreements equivalent to US$2.1 billion.[3]

This paper measures the net impact of exchange rate movements on the return of the stock of multinationals. This exchange rate exposure is measured while controlling for the use of FCDs. The study furthers the research in this area by measuring exchange rate exposure from a broad cross section of the economy, while holding hedging activity constant so as to identify the exposure that these firms are attempting to reduce. Previous research has identified exchange rate exposure for primarily manufacturing firms and smaller companies. However, other research has shown that there is widespread use of FCDs in many industries and among many differently sized firms. To study this question, a standard model of economic exposure is estimated for a sample of 276 US multinational corporations, from many different industries, over the period 1992–1996. The model measures exposure to exchange rate movements through various channels and estimates the effect of FCDs on the firms' overall exposure. The results support the hypothesis that the use of FCDs mitigates the effect of changes in exchange rates on the firm.

By controlling for hedging activity, this paper provides evidence that early studies found insignificant effects for most multinational firms, not because they have little or no exchange rate risk, but because hedging can reduce these risks. This study also furthers more recent research that shows a decline in exposure following the start of FCD use by firms. The results presented here show that the exchange rate exposure for large, US multinationals is significant, but that hedging activities by firms reduce such risk.

[1] *The Annual*. McDonald's 1997 annual report, p. 21.

[2] Statement of Financial Accounting Standards No. 105 requires firms to report the value of financial instruments with off-balance sheet risk such as futures and forwards for fiscal years ending after June 1990.

[3] The notional value is the face value, or theoretical value, of the financial instrument.

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