Firm-level exchange rate exposure in the Eurozone
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1. Introduction

One of the purported benefits of a single currency zone is that foreign exchange risk is eliminated for intra-zone trade and investment, reducing uncertainty for firms operating across national borders (Eichengreen, 1990). For the Eurozone specifically, the elimination of exchange risk has been cited in various EU policy documents as an important benefit of Eurozone membership (see, for example, EU, 1995; EU, 2007). With the Eurozone now 10 years old, it is timely to look at Eurozone firms’ exchange exposure, a topic that has received surprisingly little empirical attention. We examine the issue by comparing the exchange exposure of a sample of Eurozone and non-Eurozone European firms. Our data set comprises 1154 firms from 11 European countries – 7 Eurozone members: Belgium, France, Germany, Italy, the Netherlands, Portugal and Spain, and 4 non-Eurozone countries: Norway, Sweden, Switzerland and the UK.

In the first stage of our research, we estimate firm-level exchange exposure in two periods: the pre-euro period from January 1990 to December 1998, and the post-euro period from January 1999 to January 2008. This is conducted using the technique pioneered by Jorion (1990) that has become standard in the exchange exposure literature, involving a time-series regression of changes in the trade-weighted exchange rate against the return on a firm’s stock, while controlling for market effects. Contrary to expectations, we find that in the post-euro period, Eurozone firms have higher exchange rate exposure than non-Eurozone firms. The increase in firm-specific exposure was offset by a substantial reduction in market-level exchange exposure in most Eurozone countries, so the advent of the euro appears to have been associated with a shift in exchange risk from systematic to firm-specific. We also find that post-euro, Eurozone firms’ exchange exposure is significantly greater than that of non-Eurozone European firms. This difference, however, disappears after controlling for several country-specific and firm-specific characteristics that potentially influence firms’ exchange exposure.

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1 This is in contrast to Bartram and Karolyi (2006), who found a reduction in exchange exposure after the advent of the euro, although this was economically and statistically small. Bartram and Karolyi’s data set, however, extends only to the end of 2001.
We find that market-level exchange rate exposure has declined in Eurozone countries by more than it has in non-Eurozone European countries.

Second, we investigate why firms in the Eurozone have higher exchange exposure than firms in our sample of non-Eurozone countries. Using the exchange response coefficients estimated from the firm-specific time-series regressions as the dependent variable, we run cross-sectional regressions to determine whether this difference can be explained by country-level and firm-specific factors that have been found in prior studies to explain exchange exposure. The country-level factors are economic openness, shareholder rights and creditor rights; and the firm-specific factors are size, industry, and four financial ratios: debt-to-assets, market-to-book, dividend payout and the quick ratio. After controlling for these characteristics, we find no difference between the firm-specific exchange exposure of firms within and outside the Eurozone.

The remainder of this paper is structured as follows. In Section 2 we describe our approach to estimating firm-level exchange exposure and present our data set. Sections 3 and 4 present our findings on firm-level and market-level exchange exposure respectively. In Section 5 we discuss and present our findings on the firm-level pooled cross-sectional analysis, and in Section 6 we discuss the implications for corporate strategy. Section 7 provides concluding comments.

2. Methods and data

2.1. Exchange rate and stock market index data

Our sample comprises firms in seven Eurozone member countries: Belgium, France, Germany, Italy, the Netherlands, Portugal and Spain; and four non-Eurozone European countries: two EU members – Sweden and the UK, and two non-EU – Norway and Switzerland. Our exchange rate data are IMF monthly nominal effective trade-weighted exchange rates from January 1990 to January 2008 (sourced from Datastream), with an increase in the exchange rate index indicating an appreciation of the currency. Our stock price and market index data are also from Datastream, and the index data are Datastream weighted indexes for each country. We divide the data into two nearly equal time periods: January 1990 to December 1998 and January 1999 to January 2008. Summary information on the exchange rates (mean and standard deviation of the log change for each period) and exchange rate arrangements of our sample countries is presented in Table 1. As expected, exchange rate volatility falls for the Eurozone countries after the introduction of the euro, from an average standard deviation of 1.02 to 0.65. Volatility also falls for the Swedish, Swiss and UK currencies, but it rises substantially from the 1990s to the 2000s for Norway. This may be because Norway switched from a managed float (in place from 1992 to 2001) to an independent float in 2002.

2.2. Estimating firm-level exchange exposure

Adler and Dumas (1984) suggested that the foreign exchange exposure of a firm can be quantified by measuring the sensitivity of equity returns to exchange rate changes. An extensive body of work has subsequently examined the relation between exchange rate exposure and firm value using this and similar approaches, although it has mostly been
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