Emerging Markets Review 21 (2014) 156–182

Contents lists available at ScienceDirect

Emerging Markets Review

journal homepage: www.elsevier.com/locate/emr

Exchange rate regimes and foreign exchange exposure: The case of emerging market firms

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ARTICLE INFO

Article history:
Received 23 May 2014
Received in revised form 24 July 2014
Accepted 2 September 2014
Available online 10 September 2014

JEL classification:
E42
F31
F33

Keywords:
Foreign exchange exposure
Exchange rate regimes
Emerging markets

ABSTRACT

We investigate the influence of exchange rate regimes on the foreign exchange exposure of emerging market firms. Using a sample of 1523 firms from 20 countries for the period December 1999 to December 2010, we find that about half of the firms are significantly exposed to exchange rate fluctuations. We find that non-floating exchange rate arrangements are associated with more widespread exposure as well as a greater magnitude of firms' exposure. Cross-sectional analyses suggest that the exchange rate regime is an important determinant of firm-level exchange rate exposure for emerging market firms, and that pegged exchange rate regimes amplify exposure. This result holds after controlling for a wide range of potential determinants of firm-level and country-level foreign exchange exposure. Our findings suggest that exchange rate regime matters at the micro as well as the macro level; non-floating regimes fail to protect firms from exchange rate exposure.

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1. Introduction

According to Calvo and Reinhart (2002) there is an epidemic of 'fear of floating' among emerging economies. This 'epidemic' appears to have been exacerbated by the financial crisis; emerging economies have recently shifted toward more stable exchange rate regimes and away from floating arrangements (IMF, 2011). Proponents of 'fear of floating' often focus on the ability of stable exchange rates to facilitate bilateral trade (Frankel and Rose, 2005; Klein and Shambaugh, 2006), reduce the output cost associated with exchange rate fluctuations (Lahiri and Végh, 2002), and reduce inflation (Ghosh et al., 2002). Yet opponents emphasize that pegged exchange rate

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http://dx.doi.org/10.1016/j.ememar.2014.09.001
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regimes are associated with weaker economic growth (Cruz-Rodriguez, 2013; Levy-Yeyati and Sturzenegger, 2003; Petreski, 2009) and greater financial fragility (Burnside et al., 2001; Chang and Velasco, 2000; Eichengreen and Hausmann, 1999).

This ‘fear of floating’ debate focuses on the effects of the exchange rate regime on macroeconomic outcomes. In this paper, we provide insight into the debate from a microperspective — by exploring the effects of exchange rate regimes on firm-level foreign exchange exposure. There are three main reasons why the exchange rate regime might affect firms' foreign exchange exposure. First, a country's exchange rate arrangement is an important determinant of exchange rate volatility — fixed regimes are associated with lower exchange rate volatility (Rossi, 2009). Volatility engenders firms' direct foreign exchange exposure — which arises for firms with foreign assets and liabilities as well as expected future foreign currency cash flows. Volatility also affects firms' exposure indirectly. Several scholars have argued that exchange rate volatility increases the cost of hedging (Arteta, 2005; Eichengreen and Hausmann, 1999; McKinnon, 2000), which may result in less hedging activity and thus higher foreign exchange exposure. Second, the ‘moral hazard hypothesis’ advanced by Eichengreen and Hausmann (1999) suggests that pegged exchange rates can be viewed as an implicit government guarantee — which may diminish firms' incentives to hedge and promote the use of unhedged foreign currency debt (Burnside et al., 2001; Fischer, 2001; Schneider and Tornell, 2004). Third, under fixed or heavily managed exchange rate regimes, firms (or their creditors) may regard an extreme devaluation or appreciation as a rare event, and therefore underestimate, neglect or even are not aware of the associated exchange rate risk (Kamil, 2006, 2012). They are thus less likely to actively engage in hedging to mitigate their foreign exchange exposure.

It is likely, therefore, that a country's exchange rate regime has a major impact on the foreign exchange exposure of its firms. However, there have been very few studies of this issue. Parsley and Popper (2006) examined firms' foreign exchange exposure in several Asian markets for the period January 1990 to March 2002, and found that during dollar peg periods firms were highly exposed to movements in the dollar, and in some countries more firms were significantly exposed to the dollar with a peg than without one. Patnaik and Shah (2010) studied the foreign exchange exposure of the 100 most liquid Indian stocks from April 1993 to March 2008, and found that firms experienced higher exposure in periods when the currency was less flexible. While these studies provide some clues as to the relation between exchange rate regimes and firms' foreign exchange exposure, they did not examine how the country's foreign exchange regime affected firms' exposure, and nor did they look at the effect of exchange rate regimes on the extent to which firms are exposed. Given the recent shift toward less flexible exchange rate systems in emerging markets, it is timely to revisit the issue of exchange rate arrangements and firm-level foreign exchange exposure.

This paper has three main novel features. First, we are the first to closely study the relation between exchange rate regimes and firm-level foreign exchange exposure. That is, we examine firms' exchange rate exposure across countries with different exchange rate regimes, and we also investigate whether exposure alters when exchange rate arrangements change. Second, we examine whether and by how much exchange rate regimes determine firms' foreign exchange exposure. According to Chue and Cook (2008), Choi and Jiang (2009), Hutson and Stevenson (2010), Aggarwal and Harper (2010) among others, the magnitude of a firm's foreign exchange exposure may be associated with certain firm-specific traits (such as size, growth opportunities, and expected financial distress), and country-specific characteristics (such as trade openness and the corporate governance environment). Controlling for a wide variety of factors that are known to affect exchange rate exposure, we examine whether the exchange rate regime is a significant determinant of emerging market firms' exposure. Third, we use a unique data set that is larger than any used in prior studies. Our data set comprises 1523 firms in 20 emerging markets for the period December 1999 to December 2010. During this period, according to the IMF's database of exchange rate arrangements, 2 of these 20 countries had exclusively pegged exchange rate arrangements, 11 had exclusively floating exchange rates, and 7 alternated between floating and pegged regimes. This diversity of exchange rate systems enables us to examine whether firms' exchange rate exposure differs under floating versus non-floating regimes, as well as how exposure varies with changes in the exchange rate regime in the country in which the firm is based. Further, a series of sub-period analyses allows us to examine how emerging market firms' exposure has changed over time, including during the recent global financial crisis.

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