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Unremunerated reserve requirements, exchange rate volatility, and firm value

Chaiporn Vithessonthi^{a,1}, Jittima Tongurai^{b,*}

^a Department of Accountancy and Finance, School of Business, University of Otago, PO Box 56, Dunedin 9054, New Zealand

^b NIDA Center of Integrated Tourism Management Studies, National Institute of Development Administration, Bangkokpi, Bangkok 10240, Thailand

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ABSTRACT

In this paper we investigate whether the imposition of the unremunerated reserve requirement on capital inflows influences exchange rate volatility and stock prices. Our analysis shows that exchange rate volatility of the Thai baht against four major currencies—the US dollar, the British pound, the euro, and the Japanese yen—appears to be larger during the period of the imposition of the unremunerated reserve requirement in 2006–2007. Using a data set of publicly traded firms in Thailand, we find that the exposure of firms to exchange rate volatility appears to change during the unremunerated reserve requirement period relative to the pre- and post-unremunerated reserve requirement period. We also find that the effect of exchange rate volatility during the unremunerated reserve requirement period on stock returns is stronger for some firms than others. The results suggest that the unremunerated reserve requirement affects asset prices, through larger exchange rate volatility and through changes in exposure of firms to exchange rate volatility.

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1. Introduction

Does exchange rate volatility affect firm performance? This question is important for at least two reasons. First, policy makers such as central bankers generally assume that high levels of exchange rate

* Corresponding author. Tel.: +66 2727 3680; fax: +66 2375 4222.

E-mail addresses: c.vithessonthi@mac.com (C. Vithessonthi), jittima.t@nida.ac.th (J. Tongurai).

¹ Tel.: +64 3 479 8060; fax: +64 3 479 8171.

volatility have a negative effect on international trade. Therefore, one of the goals of monetary authorities is to minimize exchange rate volatility. Several scholars suggest that exchange rate volatility associated with flexible exchange rates tends to adversely affect economic activities such as investment (Darby et al., 1999), export (Baak et al., 2007; Sauer and Bohara, 2001), and asset prices (Bodart and Reding, 1999). For example, Bagella et al. (2006) find that real effective exchange rate volatility is associated with the growth of per capita income. Bodart and Reding (1999) find that stabilizing exchange rates reduces the volatility of asset prices. However, several studies show that exchange rate volatility has a positive effect on trade flows. For example, McKenzie and Brooks (1997) find that exchange rate volatility is positively related to the volume of export from Germany to the US over the period 1973–1992. Likewise, McKenzie (1998) shows that exchange rate volatility has a positive effect on Australia's exports during the period 1947–1995. Overall, as noted by Sauer and Bohara (2001), the positive effect of exchange rate volatility on exports documented in prior studies remains puzzling and appears to vary across countries, thereby requiring further examination.

Second, the question of the effect of exchange rate volatility on firm performance becomes even more crucial when monetary authorities consider using capital controls such as a market-based restriction on capital inflows in the form of the unremunerated reserve requirement (URR) rather than undertaking foreign exchange interventions. Since scholars and policy makers typically assume the negative effect of exchange rate volatility on firm performance, there is an ongoing discussion about how monetary authorities in both small and large economies should, and could, effectively deal with exchange rate movements, with the view that less volatile exchange rates are beneficial to international trade and national economies. It is well documented that, even in the free floating foreign exchange of the post Bretton Woods system, several central banks (e.g., Japan, Germany and the US) are active in foreign exchange intervention operations (see e.g., Bonser-Neal and Tanner, 1996; Dominguez, 1998; Meese, 1990). A survey of Neely (2008) shows that monetary authorities do not agree that foreign exchange interventions cause exchange rates to be more volatile. Empirical evidence suggests that foreign exchange intervention appears to have no effect on exchange rate volatility (see e.g., Bonser-Neal and Tanner, 1996). Capital account restriction is another important tool for monetary authorities to deal with exchange rate movements. In recent years, we have observed that emerging market economies sometimes adopt the unremunerated reserve requirement as a means to reduce exchange rate fluctuations or prevent a rapid appreciation of a currency. Several countries such as Chile, Colombia and Thailand had implemented the unremunerated reserve requirement during the 1990s–2000s (Edwards, 1998a; Edwards and Rigobon, 2009).

We notice that empirical studies on the effect of foreign exchange interventions on the volatility of exchange rates provide mixed results. While several scholars (e.g., Bonser-Neal and Tanner, 1996; Dominguez, 1998; Fatum, 2008; Rogers and Siklos, 2003) find that there is little evidence to suggest that the monetary authorities' interventions in foreign exchange market decrease the volatility of exchange rates, some scholars (Kim and Pham, 2006; Rogers and Siklos, 2003) find that foreign exchange interventions appear to lower the volatility of exchange rates. Furthermore, several researchers (e.g., Dominguez, 1998; Frenkel et al., 2005) report that interventions in foreign exchange markets are positively associated with exchange rate volatility.

The findings in prior studies show that exchange rate volatility is associated with firm value. For example, Sercu and Vanhulle (1992) find that the relation between exchange rate volatility and the value of exporting firms is positive. It has also been found that exchange rate volatility is likely to affect the volatility of an internationally integrated stock market. More specifically, Kearney (1998) finds that during 1974–1994 the exchange rate volatility appears to influence the Irish stock market volatility. Koutmos and Martin (2003) find a negative relationship between the exchange rate volatility and the US stock index return during the sample period of 1992–1998. However, some scholars such as Devereux and Engel (2003) suggest that exchange rate volatility does not necessarily cause a negative effect on the domestic economy under certain circumstances.

There is still little known about the indirect effect of the restrictions on capital inflows such as the unremunerated reserve requirement on firm performance through changes in exchange rate volatility. An important finding, as suggested by Edwards and Rigobon (2009), is that the unremunerated reserve requirement leads to larger exchange rate volatility. Scholars and policy makers who support the use of the unremunerated reserve requirement are likely to postulate that the positive effect of the

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