Time-Varying Exchange Rate Exposure: A Case Study in Asian Emerging and Frontier Countries

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ABSTRACT

Due to the potential adverse effects of exchange rate fluctuations on the economy, the exchange rate study has remained a significant subject of empirical investigation (Bartram & Bodnar, 2007; Iannuzzi & Berardi, 2010). Although there is a wide range of research, empirical evidence has shown mixed support for the theory of exchange rate exposure. The reason for this is that, for both developed and developing countries, the proportion of firms exposed to exchange rate movements is lower than expected by the theory. A study by El-Masry et al. (2007) on the UK, for example, non-financial firms reported that less than 30% of the firms sampled had significant USD and Japanese yen exposure. This was referred to as the puzzle on exchange rate exposure (Bartram et al., 2010; Bartram & Bodnar, 2007; Dimitriou et al., 2013; Hutson & Laing, 2014; Kang et al., 2016; Makar & Huffman, 2013; Takagi & Shi, 2011). Re-examining the previous literature on the traditional exchange rate exposure model based on CAPM shows that some previous studies in frontier and emerging markets (Bacha et al., 2013; Du et al., 2014; Jorion, 1990; Lin, 2011; Muller & Verschoor, 2007; Parsley & Popper, 2006; Verschoor & Muller, 2007; Ye et al., 2014) have paid less attention to some critical problems that could lead to inefficiency in the exchange rate exposure model to fully capture the exposure of the firm to the exchange rate. One of the issues is that the exposure to the exchange rate has had a time variance or is not constant over time. This is due to the fact that there is a potential instability of the risk exposure of the firm because the changing environment can affect the competitive position of the firm, the operational structure and the hedge strategies (Bartram et al., 2010; Parsley & Popper, 2006). Thus, it is unrealistic to assume that the exchange rate exposure of a firm remains constant over time, because the risk structure of any given firm will vary over time (Dominguez & Tesar, 2006; Pierdzioch & Kizys, 2010). For example, companies dynamically adjust their risk structures (e.g., exposure to exchange rate risk) in response to their internal and external environments. Therefore, this paper aims to investigate the time-varying exchange rate exposure of large non-financial firms' share returns in selected Asian and emerging countries to explore alternative explanations for the exchange rate exposure puzzle.

Keywords: Exchange Rate Exposure, Time-Varying, Global Financial Crisis, Asian Countries, Emerging Countries, Frontier Countries