7. Findings and Implications

The purpose of this study is to examine the impact of unanticipated changes in exchange rate on firm value and to investigate the effect of firm-level internal corporate governance mechanisms on exchange rate exposure. The empirical results yield several key findings that have important theoretical and practical implications. The study finds that roughly 68.6 percent of sample firms are significantly affected by unanticipated changes in exchange rates. This is consistent with prior studies on emerging markets that report more than half of their sample firms with significant exposure (Bacha et al., 2013; Kiymaz, 2003; Parsley & Popper, 2006; Tsai et al., 2014; Ye et al., 2014).

The study reveals that there are more firms significantly exposed (72 percent of sample firms) when the effects of central bank interventions are taken into account. Also, the incorporation of the effects of central bank intervention is able to detect higher magnitude of average exposure coefficients. These findings are robust to industry-level evidence, to the use of alternative market portfolio index, to alternative sub-periods and to the use of different forecasting models of exchange rates.

The estimation of exchange rate exposure coefficients during the two sub-periods of varying level of central bank intervention further uncovers the fact that firms face higher exposure during the sub-periods of higher level of interventions. This is consistent with the moral hazard hypothesis advanced by Eichengreen and Hausmann (1999) which says that firms remain unhedged due to an implicit government guarantee.

These findings suggest that intervention by central bank, through its effects on exchange rates, has a major impact on the level of Indian firms’ exchange rate exposure. The generality of these findings can be extended to other emerging markets that have managed floating exchange rate regime. This is consistent with the recent findings of Ye et al. (2014) which
suggest that the exchange rate regime of a country is a significant determinant of firms’ exchange rate exposure.

These findings have important theoretical and practical implications. In terms of theoretical significance, the results explain the existing exposure puzzle by providing evidence that intervention by central bank is a major factor which affects the exchange rate exposure of firms. In this way, this study contributes to the extant literature which attributes the insignificant empirical findings to exposure measurement biases. The findings also extend the existing theoretical literature of the moral hazard hypothesis which says that the implicit government guarantee in the form of interventions in the foreign exchange market by central bank induces firms to remain unhedged and therefore firms face higher exposure during periods of larger intervention.

The findings have important practical implications for corporate managers to anticipate the exchange rates and the associated unanticipated exposure of their firms to exchange rate risk. The firms of emerging countries that follow managed float exchange rate regime should take into account the effect of central bank intervention while gauging the future exchange rates and exposure. The accurate estimation of unanticipated exposure can further help managers to frame their hedging policies. In this way, this study suggests a new efficient approach for managers to accurately measure the currency exposure of their firms by using information on central bank intervention. The findings are also important for investors to assess the currency exposure of the firms which could help them to construct their portfolio.

Concerning the direction of exchange rate exposure, the study finds that overall, an appreciation of Indian Rupee is associated with positive stock returns. These findings are in contrast to the theoretical expectation but, surprisingly, supported by previous studies on emerging markets (Chue & Cook, 2008; Dominguez & Tesar, 2006; Muller & Verschoor, 2007; Tsai et al., 2014; Ye et al., 2014). These findings can be attributed to the reliance of
Indian firms on imported material for the production and exports to the world market. Additionally, the heavy short-term capital inflow and outflow to India in recent years may be the other possible reason behind this phenomenon. Tsai et al. (2014) brings out the role of hot money, i.e. short-term entry and exit of international capital, in influencing the stock market. Since the inflow of speculative foreign capital increases stock prices (Zhang & Fung, 2006), it might be possible that this foreign investment or speculation effect swamped the underlying ‘standard’ market reaction to exchange rate movements and led to positive stock returns in Indian market. This finding is important for decision makers and participants in the spheres of international finance, trade and policy making.

This study also explores the potential impact of firm-level internal corporate governance on the exchange rate exposure of firms. The study finds that a strong firm-level internal corporate governance environment, in which the agency costs and monitoring problems are lower, is associated with reduced level of exchange rate exposure. The explanation for these findings is that in the presence of strong internal governance, managerial conflicts are lower and therefore, managers indulge more in value-enhancing hedging activities. This reduces the exposure of firms to exchange rate risk. The findings complement the work of Hutson and Stevenson (2010) which finds that strong country-level governance mechanisms reduce exchange exposure of firms. Using currency derivative usage as a valid proxy of hedging and risk management activities conducted by firms, the study further examines the impact of currency derivative usage on exchange rate exposure under different governance mechanisms. The findings reveal that the use of currency derivatives is more effective in reducing exposure for firms that have strong firm-level governance and are associated with greater reduction in exchange exposure as compared to weakly governed firms. These findings are robust to alternative sample sub-periods, to proxy indicators for firms’ hedging
activities, to alternative control variables and to various exchange exposure coefficients estimated with different models and at different significance levels.

The findings of this study underline the importance of taking into account the strength of internal governance in resolving the existing exposure puzzle and suggest that corporate governance may explain why hedging is ineffective for some firms and is not able to reduce their exposure to exchange rate risk. In this way, these findings eliminate some of the ambiguity in the current empirical literature. The study also adds to the existing theoretical literature which suggests that corporate governance environment has a significant role in influencing value enhancing managerial activities.

The study has important implications on how investors should assess firms’ exposure to exchange rate risk and suggests that quality of internal corporate governance helps them infer that currency derivatives usage is done for optimal hedging reasons, thereby yielding a significant reduction in exchange rate exposure.