

FIRM-LEVEL INTERNAL GOVERNANCE, HEDGING INCENTIVES AND
EXCHANGE RATE EXPOSURE



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Abstract

This study addresses two research questions in an attempt to explain the mixed evidence of the relationship between changes in exchange rate and firm value. First, how do unanticipated changes in exchange rates affect the value of the firm? Second, how does firm-level internal corporate governance affect the level of the firm's exchange rate exposure?

Using a sample of 651 Indian firms over the period 2001 to 2013, this study discovers a statistically significant and economically important relationship between unanticipated changes in exchange rates and the value of the firm. Using a Vector Error Correction Model (VECM) to generate unanticipated exchange rate changes, this study provides new evidence that the intervention by the 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.

By constructing an aggregate firm-level internal corporate governance index based on the ownership structure of firms, the study uncovers that the strong firm-level internal governance, in which the agency costs and monitoring problems are lower, is associated with a reduced level of exchange rate exposure. The study also reveals that the use of currency derivatives is associated with greater reduction in exchange rate exposure for firms that have strong firm-level governance as compared to weakly governed firms.

The study complements prior attempts to explain the existing 'exchange rate exposure puzzle' and has important theoretical and practical implications.

Key words: Exchange rate exposure, central bank intervention, firm-level internal governance, India

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