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EXCHANGE RATE EXPOSURE AND FIRM-LEVEL PERFORMANCES: THE CASE FOR MACEDONIA

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Abstract

Changes in exchange rates, unless they are expected, can impact the decision making and profitability of financial and non-financial firms. In particular, with the adoption of flexible exchange-rate regimes in the early 1970s, exchange-rate risk, contrary to expectations, has led to an increasingly riskier environment for firms with international transactions. However, a riskier environment does not necessarily mean higher risk at the firm level as firms can take advantage of risk-management practices in order to lower or completely eliminate that risk.

Most investors will be familiar with the concept of currency exposure, with constantly changing exchange rates affecting the cost of investing in international securities. These same issues also affect companies that operate internationally. So what effect do currency fluctuations have on company profits, and what are they doing to insulate themselves? In this paper we examine this question. We surveyed financial and general managers of companies in Macedonia in order to examine their views and practices about this important questions. It is useful to identify which are exporters and those who seek to provide value in areas like managing foreign exchange risk and predict currency needs. Key factors for realization of these goals are also innovation and knowledge that can help in increasing the role of FDI on productivity and efficient growth with the real exchange rate by stimulating the growth of exports. This can contribute for

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sustainability of economic growth and economic integration, especially for small and open economy such as Republic of Macedonia, also subject of analysis in this paper.

Keywords:

Exchange rate exposure; Real exchange rate; firms; risk; Macedonia.

1.INTRODUCTION

It is widely acknowledged that in an open economy, the exchange rate constitutes the most important price. The existence of exchange rate exposure can be very painful as examples from several emerging economies have shown. Although the rapid growth in international investments reflects the benefits of geographic diversification, currency risk can counteract some of these advantages (Edwards, 1998). Since foreign exchange rates can have a significant impact on returns, investors may be interested in hedging this risk where possible and appropriate. Investments in overseas instruments, such as stocks and bonds, can generate substantial returns and provide a greater degree of portfolio diversification, but they introduce an added risk, that of exchange rates. While hedging instruments such as currency futures, forwards and options have always been available, their relative complexity has hindered widespread adoption by the average investor. Given the differences in risk-management practices, a firm's level of exposure to exchange-rate changes cannot be proxied by the standard deviation of relevant exchange rates or other more complex measures.

This paper was motivated by the increasing role of foreign exchange debt in financing small and medium-sized enterprises. FX debt, if not hedged, exposes firms to depreciation, which may result in losses for the banking sector as well. There are other channels through which the credit risk of

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corporations is also influenced by exchange rate changes. Financial crisis and exchange rate exposure literature is reviewed to highlight the significance of this issue.

We will first present the theoretical foundation, then we will present the research methodology, and finally we will discuss the findings.

2. THEORETICAL LITERATURE REVIEW

Exchangerate exposure can also show asymmetric behavior where currency appreciations and depreciations impact firm value differently, both in direction and in size (e.g., Bartov & Bodnar (1994), Koutmas & Martin (2003)). A recent and thorough survey of the literature on exchange-rate exposure is provided by Muller & Verschoor (2005). Yet there is no clear consensus among economists on whether the type (or degree of flexibility) of the exchange rate regime affects the corporate sector's incentives to take on foreign currency denominated liabilities or to insure against depreciation risk.

Two basic views exist in this respect. On the one hand, several authors have argued that pegged exchange rate regimes biases corporate borrowing towards foreign currency, due to an implicit exchange rate guarantee given by the government (Mishkin,1996; Goldstein and Turner, 2004). Under fixed or pegged regimes, the central bank keeps currency volatility within a pre-announced range, effectively underwriting currency risk (Dooley, 2000). Thus, firms borrow in dollars to benefit from the lower ex ante dollar interest rates, and expect the government to insure them from any potential loss in the event of a large devaluation. A second variant of this argument suggests that because of limited exchange rate volatility under fixed or tightly managed exchange rate regimes, borrowers appear to consider a steep devaluation a

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low-probability event, and therefore neglect or underestimate the exchange rate risk associated with borrowing in foreign currency. The fact that fixed/pegged exchange rates have played a role in every recent financial crisis since 1994, and that firms relied extensively on unhedged foreign currency financing in the years leading up to the crisis, is often used as strong evidence for these views (Dooley, 2000).

On the other hand, (Eichengreen and Hausmann (1999) and Eichengreen, Hausmann, and Panizza (2005) dispute this view. The authors suggest that at the root of currency mismatches lies the fundamental inability of emerging markets to borrow abroad in their own currency. Inevitably, this leads to an accumulation of foreign-currency denominated debt which firms are simply unable to hedge, even if they have the foresight or prudence to match the currency structure of their assets and liabilities. In addition, McKinnon and Pill (1999) argue that adopting a floating rate regime will actually exacerbate currency mismatches. Because the domestic interest rate risk premium is a direct function of the stability of the currency, exchange rate volatility associated with floating rates will increase domestic interest rates (and thus the incentives to borrow in foreign currency) and make financial hedging more expensive.

3. EXCHANGE RATE EXPOSURE FOR MACEDONIAN COMPANIES

Refinancing risk is significant for Macedonia. It will need to repay large Eurobonds maturing in 2013 and 2015, as well as the PLL purchase (in 2014–16) and the bank loan guaranteed by the World Bank PBG (in 2016) . Market volatility has been high since the onset of the global crisis, due to external rather than domestic factors. This was evident in 2009, when the government issued a 3½-year Eurobond at a yield of

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9⅞ percent, more than double the 4⅝ percent yield of the 10- year issuance in 2005, and in 2010 when it canceled a planned Eurobond issuance after market rates spiked in the run-up to the Greek program. In addition, domestic debt features a very short average maturity of just 6 months, and hence the need to roll over existing debt on average 2 times per year.

Macedonia's exposure to currency risk could gradually be reduced by increasing domestic non FX-indexed denar issuance. Currency exposure is considerable: all external debt is in FX, and almost half of outstanding domestic government debt is FX-linked. Taken together, almost 90 percent of general government debt is hence denominated in or linked to foreign currency. Currency risk—defined as the (high) exposure multiplied by the (low) probability of a shock—may not appear to be high in light of the stability of the peg over the past 15 years (Loderer & Pichler, 2000). However, reducing it would add to policy flexibility in the event of unforeseen shocks in the future. Gradually increasing the share of domestic denar-denominated, non FX-linked debt would be a prudent strategy in this context, together with increasing the share of domestic debt in fiscal financing. These actions would also bring other benefits, including developing the domestic currency yield curve, improving the monetary policy transmission mechanism, and in general promoting greater use of denars in financial transactions.

By developing and following a medium-term debt strategy along these lines, Macedonia can achieve the goal of minimizing medium-term costs subject to keeping risks within appropriate pre-set bounds. As described above, the government has taken the first initial steps toward renewed market development. Further gradual moves in this direction, guided by a comprehensive debt strategy, would bring the goal within reach. Achieving this goal would benefit the budget through lower interest expense and lower risks

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over the medium term. At the same time, developing a domestic yield curve would yield positive externalities for the real economy, as it would clearly establish a denar yield curve that can be used in pricing private sector loans and bonds.

Traditionally, Macedonia has had low fiscal deficits, ranging from –1% to +1%, but during the crisis in 2009 this grew initially to 2.5% then to 2.8% with our highest in 2012 at 3.8%. In 2013, due to the financial stimulus were at 3.5%. NBRM was able to mitigate successfully because Macedonian public debt was low at around 20% of GDP which afforded us room for expansion which we used during this crisis period. Apart from the macro-economy concerns, the crisis with the Euro as a currency helped boost confidence in Macedonian domestic currency [MKD denar]. This is because people naturally began to wonder what would happen with Europe; therefore, its primary currency. As a result, some people began to orient more towards the MKD. Macedonia, like most former Yugoslavian countries are highly Euro-rized, which means people save and use credits in Euros, with a 65% Euro to 35% MKD ratio. During the crisis and continuing today, the ratio of households and their propensity to save in MKD has elevated to 50%.

4. METHODOLOGY

The study involved a field survey conducted in July 2015, by applying a self-administered questionnaire which was distributed among the managers and employees in companies in Macedonia. The survey contained questions on accounting exchange rate exposure. The aim was to collect data and to examine the behaviour of enterprises. Analysis of the data was conducted with a focus on exchange rate

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exposure. The analysis is based on descriptive statistics and probit and ordered probit regressions. Also, we investigated managers' attitudes about the impact of business strategies on the intended financial strategy.

In 45 companies we asked managers what encourages and what limits the use of debt:

- High volatility of EBIT (high business risk) limits the use of debt (lower financial risk);
- Diversification (operations in more businesses) encourages the use of debt;
- Internationalization (sales in other countries) encourages the use of debt;
- Long periods of collection of accounts receivable force the use of debt.

5. ANALYSIS, RESULTS AND DISCUSION

This part focuses on the firms which were asked about their opinion for their exchange rate exposure and expectations. As firms are not obliged to register the denomination of items in their books by the accounting system, the volume of FX items may be larger than reported. Firms are required to count export revenues and import expenditures, however, they may have FX income or expenditure from non-foreign trade type activity or they may have FX balance sheet items. This distortion is higher for FX assets and liabilities than for income statement items. On the other hand, the exchange rate exposure perceived by firms is underestimated as a result of low volatility of the exchange rate in the period before the survey. It may easily be the case that firms projected this situation into the future, and thus felt they had no exchange rate risk at all.

Accounting exposure or currency mismatch (CM) is defined as follows (Loderer and Pichler,2000):

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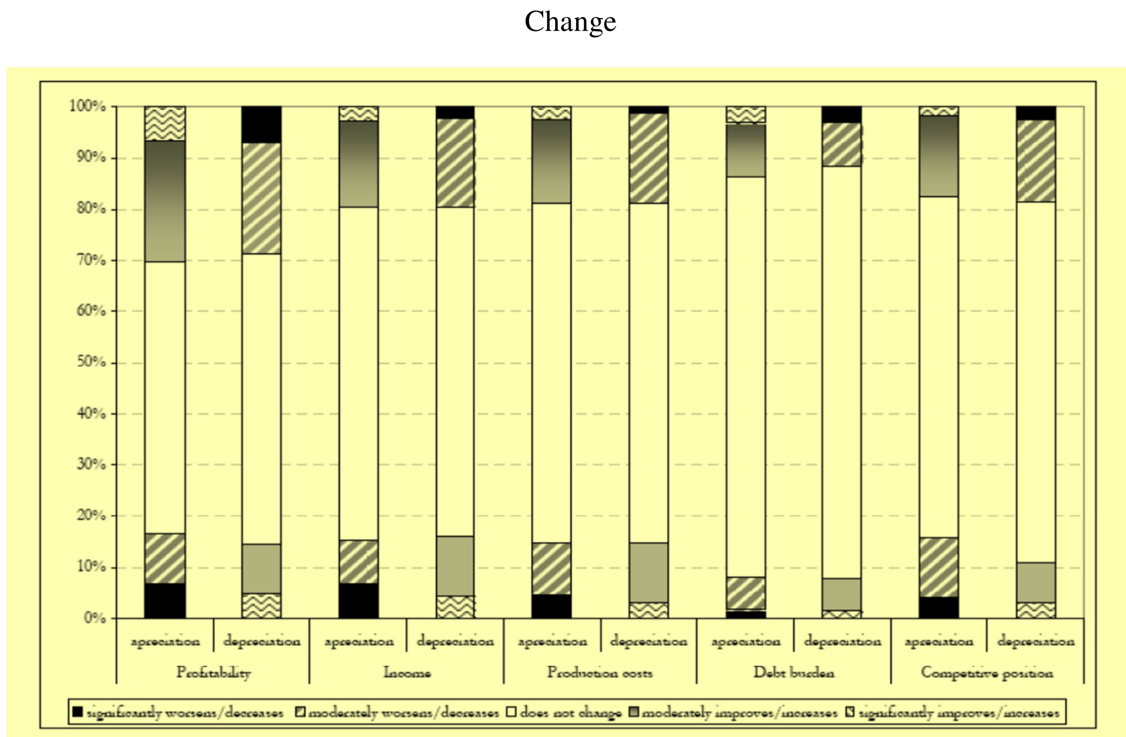
Stock CM = MKD value of FX assets – MKD value of FX liabilities

Flow CM = MKD value of FX income – MKD value of FX expenditures

In the case of a negative currency mismatch, depreciation of the domestic currency would have negative effect, while appreciation would influence the net position positively. Enterprises may have exchange rate exposure even if currency mismatch is zero, if the scheduling of inflows and outflows differs.

Figure 1: Expectations of Enterprises in Case of a Potential Exchange Rate Change



Source: Survey on the Exchange Rate Exposure of Macedonian SMEs.

The survey responses about the impact of business strategy on intended financial strategy are summarized in Figure 2 and Table 1.

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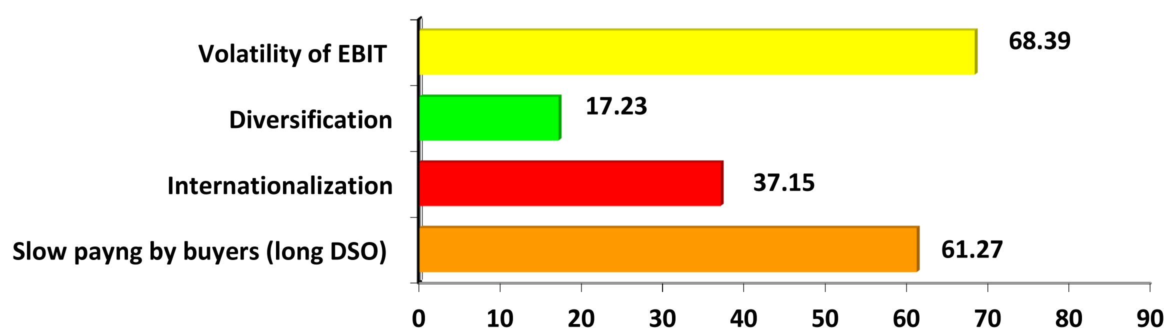
Figure 2. The impact of business strategy elements on financial strategy



Source: Authors' calculations

Table 1.The impact of business strategy elements on financial strategy

	% of companies		Mean										
	Important or very important	Unimportant or with little importance	All	Size		Industry		Internationalization		Diversification		Debt	
				L	S	FP	O	N-I	I	UnD	D	UnL	L
Volatility of EBIT	68.39	3.15	3.807	3.795	3.914	3.935	3.790	3.680	3.987	3.685	3.990	3.675	3.880
Diversification	17.23	48.40	2.463	2.176	2.725*	2454	2.564	2.503	2.572	2.280	2.803	2.286	2.607
Internationa-lization	37.15	31.05	2.807	2.414	3.130*	2.713	2.983	3.092	2.816*	2.542	3.365*	2.647	2.925
Slow paying by buyers	61.27	8.05	3.601	3.318	3.860*	3.565	3.725	3.680	3.694	3.423	3.928	3.452	3.698

*significant at the 0.05 level.

Source: Authors' calculations

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The greatest number of managers sees EBIT volatility as the most important factor of applied business strategy that influences decisions about borrowing: 68.39% believe it is an important or very important factor (mean 3.807). EBIT volatility can be viewed as a synthetic indicator of business risk in terms of implemented overall business strategy. This indicates that managers are well aware of the need to combine the effects of business and financial risks meaningfully. In contrast to the views on diversification and internationalization, managers believe that a very practical problem is an important or very important factor of business strategy that determines the level of debt: delay of buyers in meeting their liabilities to the company. More than 61% of managers agreed with this assessment (a mean of nearly 3.6). We found additional statistically significant differences in attitude between managers of small and large companies in terms of how managers see impact of internationalization on level of debt (3.130 versus 2.414).

Managers of small companies also believe more than managers of large companies that diversification encourages the use of debt (2.725 versus 2.176). Finally, not only managers of

small companies but also managers of non-internationalized companies and diversified companies are more inclined to believe that internationalization encourages use of debt. One possible explanation is that managers of small firms find that diversification requires a significant investment that cannot be provided through internal financing and it is necessary to arrange additional borrowing for this purpose. The view of internationalization that managers of diversified firms have may be influenced by their experience of additional borrowing to extend product scope (i.e., diversification), leading them to conclude that additional borrowing is also necessary when it comes to extending geographical scope (Bordo et

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al.,2009).

6. CONCLUSION

Regressions indicated that the exchange rate exposure of a firm is positively related to firm size, foreign ownership, foreign trade activity and FX indebtedness. In terms of sectors, the highest the ratio of firms exposed to exchange rate changes is found in the manufacturing sector, but in transportation and trade sectors the ratio is also higher than average. The majority of companies interviewed are not prepared for changes in the exchange rate. On the basis of their answers, most of SMEs with exchange rate exposure do not assess their exchange rate exposure or deal with its magnitude, and generally believe that they have no exchange rate exposure or that it is negligible. foreign exchange debt, as a means of natural hedging, may reduce exchange rate exposure, but if foreign exchange indebtedness is motivated by the reduction of costs (i.e. payment of lower interest rates upon borrowing, for example), the exchange rate exposure of the enterprise will grow. Several questions were posed in connection with assessing exchange rate exposure, expectations regarding the potential impact of the exchange rate on profitability, income, costs, debt and competitive position. Enterprises were asked to express their expectations on both the effects of appreciation and depreciation, as exchange rate exposure may be asymmetrical (Figure 2). Half of firms with non-zero CM gave answers, based on which it is clear that they are not aware of the existence of exposure or deem it to be insignificant. About 50% of these firms do not expect the exchange rate to affect any of the aforementioned variables. The other half of this group said they had exposure, but they do not manage it or the answers are contradictory. For example, firms answered that they had no

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exposure but expected they would be influenced by a change in the exchange rate.

In general, developing countries - the Balkan countries have a shortage of savings and they imported foreign savings. Companies in Macedonia tend to borrow in foreign currency-Euro which is particularly popular in Serbia and Croatia, due to the lower interest rates compared to interest rates on credits in national currency. Differences in interest rates are an indicator of expected future depreciation / appreciation currency in terms of fluctuating exchange rates (Zettelmeyer et al., 2010). The currency risk can be hedged in two ways: if the company is a net exporter and lend in currency of the net exports, or in short-term loans, if agreed today a term exchange rate to repay the loan at the time of the mature. But, in the Western Balkans as we have seen from the above researches there is no developed market of term rates to use this tool. Namely, as an instrument to mitigate foreign exchange risk can serve the following rule - if the company does not generate income in the same currency as the loan is, repayment capacity of the loan should not exceed 50-60 EBIT of the company. In the case of depreciation, the company has the capacity to back the loan. So, those countries which are small and open (as Macedonia) have high indicator on protection of the EUR currency risk through their exports in Euros. These sectors can avoid currency risk by borrowing in Euros.

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