One Way Bets on Pegged Exchange Rates
by
Ila Patnaik and Ajay Shah

Comments by
Michael Hutchison
UC Santa Cruz
Santa Cruz Center for International Economics
Basic Idea

• Measure “currency exposure” by regressing equity return of industry against exchange rate change, holding constant “market” return

• Details: “innovations” in exchange rates and market return uncorrelated with ex rate innovations

• Apply to India—daily data, many industries

• Results: latter periods (large reserve accumulation) more likely to have negative correlation b/t equity return and depreciation
General Comments

• Sophisticated econometric application to India
• Careful with data and econometrics
• Clearly written
• Interesting results, consistent with hypothesis that one-way bets drive currency exposure in recent years
• Possibly related to exchange rate regime
Questions

• What are implications for currency exposure positions?
  – Other studies generally find no correlation, and interpret this as hedging currency position
  – If Indian firms generally gain by INR appreciation against dollar, they must be short dollars
  – How can so many sectors in India be short dollars (net dollar liabilities) on such a large scale?
  – “Finance” approach—firms are location of assets; other approaches—firms produce things over time and have firm-specific qualities. Are all firms acting like financial enterprises?
Questions

• Consistent with other hypotheses?
  – Issue with all studies of this nature

• What other factors are correlated with exchange rate changes?
  – Fundamental causes of exchange rate appreciation
    • Strong domestic demand
    • New markets, new opportunities, new products
    • All correlated with strong returns, and maybe not in market index
Questions

• Omitted variables problem

• Should other idiosyncratic factors or common factors enter the equation in addition to the exchange rate?

• An exchange rate movement will have a different effect on different firms, depending on their market structure, hedging, etc. Are there other common variables that would also have asymmetrical effects that should be included?
Questions

• Are developments in some industries affecting exchange rate?
  – Logic is that individual firms are not (contrary evidence in Japan), but industries?

• Equity return change is NPDV of change in profit stream for all periods; Are India firm’s hedged for a long time horizon? Can this really offset loss of export markets with INR appreciation?
Comments

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Small Points

• It would be useful to review the Tesar and Dominguez results, to see what the “state of the art” is in this literature.
• Does taking exchange rate surprises follow the literature?
• Are there any problems with (by construction) making the market index to be uncorrelated with exchange rate surprises
• pg. 12, can’t explain Swedish industry results (lack of exposure) because of floating exchange rates;
Overall

• Very nice paper
• Clear results, consistent with one hypothesis
• My concern: are the results consistent with other hypotheses?
• Are Indian firms/industries really so short on dollar positions!
• Or are other common shocks leading to strong correlations between exchange rate surprises and stock returns?
• Policy conclusions too far reaching for my taste, at this stage of the research!