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Exchange rate risk and Philippine stock returns: before and after the Asian financial crisis

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Abstract

This paper examines whether the Philippine stock market prices exchange rate risk during the period 1992–2001; specifically, before and after the onset of the Asian financial crisis. Using a two-factor arbitrage pricing theory model, the evidence presented in the paper suggests that stock returns did not react significantly to foreign exchange rate fluctuations before the period of the crisis. After the onset of the crisis, however, Philippine firms started to exhibit cross-sectional differences in their reaction to exchange rate movements. Furthermore, during the post-crisis period, investors began to expect a risk premium on their investments for their perceived added exposure to exchange rate risk. In the larger, macroeconomic sense, this implies market inefficiencies in the foreign exchange or stock market or both and inadequate hedging by local firms for foreign exchange risk.

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Notes

[1] Orthogonality of factors is not really necessary for most forms of the APT. Furthermore, enforcing orthogonality may be innocuous by itself since the R^2 between the two factors is 0.0503 which has a p-value under a t-test of 0.0138.

[2] Jorion also used a six-factor model based on Chen et al. The factors were changes in exchange rate, industrial production, expected and unexpected inflation risk premium, term structure, and market excess return. The other factors are not used in this study based on the results of Aquino (2002–2003) that these other factors do not appear to be separately priced in the stock market.

[3] Both the Phisix and the all shares index are market capitalization weighted based on all outstanding shares.

[4] Using the Augmented Dickey–Fuller test, the unit root hypothesis for both series is rejected at 0.01 level of significance.