Chapter 1: Introduction

1.1 Introduction

The dramatic increase in global population and in turn its needs on the one hand and considerable technological and economical progress on the other, provide a new atmosphere for developing the relationships between different nations in all around the world. Meanwhile, the importance of the areas of South East Asia that mainly encompass the countries of ASEAN including: Malaysia, Singapore, Indonesia, Thailand, Philippines, Cambodia, Laos, Burma (Myanmar), Brunei and Vietnam that totally has enveloped a market of around 500 million people with a combined GDP of more than 600 billion USD, is undeniable.

Considering the huge potential for agricultural, manufacturing, services, and tourism sectors especially because of wealthy natural resources, and work forces with low wages and salaries among countries in southeastern of Asia, many of the outsiders have been eager to invest in this area in addition to the local parties. So, the number of companies and their activities has increased during the years. In this situation, the one important subject that most of the companies should be considering through the interactions with outsiders is the risk of the exposure to the foreign exchange rate fluctuations and how they could prevent and hedge against the risk as well. Two prominent strategies that have been used for hedging against the aforementioned risk until now are FCD (Foreign Currency Derivatives) and FDD (Foreign Denominated Debts) that are known as external hedging teckniques and these will be explained in detail in the next chapter.

Although each of the countries of the region (southeast of Asia) has its own conditions that are not necessarily the same as another, there has been a relatively high economic growth in the region during the latest three decades (except the time of the 1997 crisis) that in turn has led to a suitable condition for having more interaction with the other countries from different parts of the world; especially European countries and the United States. In this situation, although the importance of Malaysia as one of the most prominent countries in the region is obviously brilliant, as the scheming of its valuable potentials and economical condition can provide a more distinctive insight to importance of the country, so the conditions of Malaysia are reviewed hereafter. In fact, this revision could clarify more why we selected Malaysia as the area of the studies, apart from the fact that no such study has been conducted in this country yet.

Malaysia

Valuable wealthy natural resources, neutralistic foreign policy (stable condition) and supportive domestic policies, developing economical improvements, and new industrialisation with an open state-oriented market economy provide suitable conditions for absorbing foreign investments in addition to domestic investments. In this condition the number of companies and their activities in turn, has been increased continuously. So, the international interactions between Malaysian companies with outsiders via exporting the goods, natural resources, services, and even operations outside the borders of the country have been developed consequently.

International activities via exports of goods and natural resources have bloomed the economic condition in Malaysia. Petroleum, rubber, palm oil, and tin are the main natural resources for export. Except for petroleum, the other three aforementioned resources are known as the first rank of exporting from Malaysia in the entire the world.

Furthermore, as the foreign policy of Malaysia has been based on neutrality principles and maintaining peaceful relationship with the other countries, it could convince investors that their investment will be safe and under the stable condition prosperity will be more probable.

Malaysia has newly industrialized with an open state-oriented market economy as well, and from the decade of the 1980s industrial growth has dominated, so further investments in recent sector has been increased considerably. When the crisis of 1997 took place, most of the countries in the area engaged with the related problems, and Malaysia could come up with the related problems earlier than its neighbors regarding its relatively high GDP of the time prior to the crisis; 14800 USD per capita, so it has had a relatively high economic growth. As a case in point in 2007 its economy was ranked third among the countries of ASEAN and comparing with entire world, was in twenty-ninth position at the same time. During the years 2007 and 2008 it experienced the economic growth rate of 5% to 7%, and in 2008 it had a gross domestic product of 222 billion US Dollars, and this amount increased to 383 billion USD in 2009 based on purchase power parity and 14900 USD per capita.

In addition *to the large companies, Small and Medium Enterprises (SMEs) play a vital role in the country's economic development* (Muhammad, Char, Yasoa, & Hassan, 2010) as well. The trend of economic growth and the rapid industrial development that we mentioned before, has made Malaysia one of the most open economy countries in the world. In conjunction with the Ninth Malaysia Plan (2006-2010), the government is designing and allocating resources to the special plan of SME development to assist the companies to meet the new business challenges in the competitive global business environment. Hence, the companies that engage in the international markets need to care more about their operations and activities for increasing or at least protecting their values. As mentioned before, in this condition, one of the most important subjects that should be considered necessarily is foreign currency exchange rate exposure, as the influences of this exposure on the firm value have been accepted by many different parties.

In fact, exchange rate exposure has been known as a major source of uncertainty for the companies that are active in the global market, and the importance of this issue has been advocated by many researchers too. Some scholars such as Marshall (2000) mentioned the same or even more important degree than business risk for the exposure. It has had a volatility of four times more than interest rate and ten times the inflation rate within the research done by Jorion in 1990. As this volatility affects cash flows and the equity of the firms based on the concept of derivatives markets, we must not only consider making profit during our activities and transactions in international markets or at least protecting the value of the company, but also we must mention about opportunity cost that specifies the value of next best alternatives in monetary activities for convincing the investors (Chen & Raymond, 2002). Hence, for more consideration about opportunities costs and hedging against decreasing the value of the firm because of variations in exchange rates, some useful financial strategies could be prominent and two main strategies that are usually more usable by corporations are FDD (Foreign Denominated Debt) that contains any debt from outsiders (in foreign currency) and FCD (Foreign Currency Derivatives) that includes four main types of derivatives contracts. Moreover, many studies demonstrated that there is a significant relationship between firm value and hedging strategies (Allayannis, Ihrig, & Weston, 2001). In addition, some other researchers clarified the companies that involve in hedging activities not only enhance their values, but also upgrade the utility of their managers (Tufano, 1996). So, viewing the importance of the issue, the intention and purpose of this research is to clarify the situation of using these two strategies among non-financial firms in Malaysia that are relatively advanced in southeast of Asia.

Finally, the outcome of this study would be helpful for investors and corporation managers that are already active in international markets and for the other companies that intend to enter foreign markets too; since by knowing about the situation of the exposure and the effects of these two techniques in the region, they can make the right decisions at the suitable time to reduce the risk of decreasing the values of their companies. Moreover, it would be useful for governments decision makers to devote more attention to related markets like options and futures that have not been so active in comparison with developed countries until now.

1.2 Scope of the study

The data and information of using FDD that contains any foreign debt like issuing the bond in foreign currency (USD) or taking the loan from outsiders and FCD including the use of at least one kind of relevant derivatives contracts like Options, Swaps, Futures, and Forwards by non-financial firms during the period starting from the beginning of the year 2005 until the end of 2009 (the recent five years that have registered significant data) for Malaysia are required for gathering, studying and analyzing through our research. In fact, the latest five year period (2005-2009) has been selected as the specific time period for the research, because from 2005 (July 2005) the goverment had floated the exchange rate of Malaysia Ringgit to the US dollar and from that time until now the most reliable registered data could be for a maximum of five years. Moreover, the most valid sufficient data that has been accessible for the study, belongs to the selected time period. Furthermore, the selected period has conjunction with the period of the Ninth Malaysia Plan (2006-2010), that economicaly has been so important for the entire country. Besides, the main article and some other previous researches (Allayannis & Ofek, 2001) had selected a five year period as a suitable length of time for their investigations.

Since the effective volume of foreign involvement has been considered as at least 10% foreign sales based on ISA (International Standards of Accounting), GAAP (Generally Accepted Accounting Principles), and many relevant previous scholar investigations, only the non-financial registered companies that have had at least this amount of foreign sales during the specified period have considered as a base for this research.

1.3 Statement of the Problem

The Value of corporations involved in international business operations or markets are affected by unexpected fluctuations of future cash flows. Since, when a foreign exchange rate changes during the specific period of time, it can in turn influence the cash flows that have been created by the companies during the same period, and finally can lead to changes in value of the firms strongly. Mainly, two effective external strategies have been used by many corporations for hedging against exchange rate fluctuations; these are FCD (Foreign Currency Derivatives) and FDD (Foreign Denominated Debt). Most of the studies for finding the effects of using these two techniques on the exchange rate exposure and the relationships between them have been done in the United States and European countries until now, and although many related investigations have implemented recently, the most similar last research was done for non-financial firms of Taiwan in 2005 (by Yi & Hui) which is relatively new and we have selected this as the main article in this investigation. In fact, by using monthly data over the covered 5 year period (1998-2002), they tested whether FCD and FDD could reduce the risk of the exposure for non-financial firms in Taiwan or not, and the situation of using these two strategies as substituites or complements for each other as well.

Furthermore, there have not been any homogeneous researches about this subject in Malaysia until now. So, with consideration to the importance of the country especially its position within southeast Asia and its economic specifications that we explained before, and the importance of the subject, the use of FCD and FDD for hedging against the exposure of exchange rate changes, the importance of the subject for investigating seems inevitable. So, the issue that could be mentioned as problem statement in this research is:

"The risk of the exposure to foreign exchange rate fluctuations for Malaysian corporations that are involve in global markets and the situation of using FCD and FDD to reduce the risk of the exposure".

1.4 Objectives of the study:

The objectives of this research are divided into two main categories as follows:

1. Finding whether FDD (Foreign Denominated Debts) and FCD (Foreign Currency Derivatives) could reduce the risk of exchange rate fluctuations effectively for non-financial firms or not.
2. Whether these two financial techniques (FDD and FCD) can be used as complements or substitutes to hedge against the risk of the exposure to exchange rate changes.

Given the fact that there has not been the same investigation about the condition of exploiting these two financial strategies in Malaysia, especially for the recent period of time that encompasses many noticeable influential events like the US financial crisis in 2008 on the one hand, and the specifications of Malaysia as a country that has absorbed many foreign investors on the other hand, the importance of two above objectives can be more clarified. In addition, some recent related studies like the one by Ibrahim (2008) for Malaysia have emphasized and intensified the importance of the exposure in the area and vulnerabilities of different sectors to the risk of the exposure, so researching the effectiveness of two external hedging strategies (FCD and

FDD) for constraining or even removing the risk of the exposure and the optimum usages of the strategies in Malaysia could be mentioned as the main objectives of this investigation.

1.5 Organization of the Study

This research is organized into five chapters:

Chapter 1 provides brief explanations about the importance of using two strategies (FDD and FCD) for hedging against exchange rates fluctuations in Malaysia. Moreover, general atmosphere and economic conditions of the country in the region are illustrated by some usual economical indices and the scope of the research as specified within this part. Problem statement and the objectives of the study have followed the mentioned explanation as well, and finally the organization of the study has been clarified in the rest of this chapter.

Chapter 2 describes the review of the literatures about the exposure of exchange rates fluctuations and their influences on the value of the firms and using FDD and FCD as the two prominent strategies for hedging against the risk of the exposure.

Chapter 3 explains the research hypotheses and their development. Data sources and data gathering have been illustrated in this chapter too. In addition, the methodology of using collected data and their analysis are clarified in this part.

Chapter 4 specifies the findings and outcomes of the study that have been done through the testing of hypotheses. Besides, it provides the related statistical tests for the outcomes that lead to discussion about the findings.

Chapter 5 provides the justifications of the outcomes and summarizes the conclusion, clarifies the limitations that has appeared during the study and states recommendations for further and future studies.