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Market frictions and banking regulations limit the liquidity of the derivatives market, particularly affecting large firms. Foreign exchange interventions have asymmetric effects: they implicitly protect small firms under low intervention scenarios, but benefit large firms when intervention is high.

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Approach

This paper combines economic theory and empirical evidence to understand corporate behavior in the face of foreign exchange risk. It develops a theoretical model that incorporates financial frictions and entry costs into the derivatives market, validated with firm-level panel data from 2005 to 2013. The analysis focuses on how firm size, financial regulation, and exchange rate policies influence hedging decisions.

Contribution

The research reveals that large firms, despite having greater access to the derivatives market, face higher hedging costs due to their need for larger volumes, which limits their ability to protect themselves. Moreover, central bank foreign exchange interventions have nonlinear effects: moderate foreign currency sales reduce the incentive to hedge, while large sales increase liquidity and favor hedging among large firms. The study suggests that although these policies aim to promote stability, they may generate vulnerabilities in the real sector.

Findings

Empirical evidence confirms that larger firms hedge a smaller proportion of their foreign currency debt. Market frictions and banking regulations limit the liquidity of the derivatives market, particularly affecting large firms. Foreign exchange interventions have asymmetric effects: they implicitly protect small firms under low intervention scenarios, but benefit large firms when intervention is high. The study proposes that better calibration of macro-financial policies could strengthen the financial system and reduce exposure to foreign exchange risk.