

# **The Pricing of Currency Risk in the Australian Equity Market**

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## **ABSTRACT**

The pricing of currency risk in the equity market is of considerable research interest, especially in a country like Australia with a freely floating exchange rate and relatively well-developed equity and foreign exchange markets. These facilitate the existence of a capital flow effect together with the numerous firms involved in international trade which contribute to the trade effect. The presence of both these effects has undoubtedly served to heighten the volatility of the exchange rate and elevated the need to examine currency risk as an underlying source of risk in the equity market.

However, any relationship between the exchange rate and stock prices may stem from the simultaneous impact that numerous possible confounding factors have on both the variables. The object of this study is to test to see if the exchange rate affects stock prices above and beyond these confounding effects, by examining the price of the orthogonal component of the currency risk premium in the stock returns of Australian firms.

Consistent with a priori predictions, initial findings revealed that the currency exposure of multinationals, exporting and domestic firms do vary, with multinationals registering the largest exposure, and purely domestic firms demonstrating the least. Furthermore, the results also showed that currency risk is indeed priced in the stock returns of multinational firms, although it appeared to be insignificant in explaining the stock returns of exporting and domestic firms.