ABSTRACT

This paper addresses the issue of pricing of exchange rate risk in the Indian stock market during the period 2005-2016 and specifically before and after the crisis years. A two-factor APT model with the market returns and exchange rate returns as factors is employed. Industry portfolios were created to generate a substantial dispersion in exposure coefficients so that pricing tests could be effectively conducted. Empirical evidence suggests that the pricing coefficients are significant for the time periods considered post 2008. After the onset of the global financial crisis, there was a slight change in the perception of investors. In fact in the last four years, which is the latest period considered between 2012 and 2016, the exchange rate risk factor is becoming a prominent 'priced risk' in the market. This essentially means that Indian investors are increasingly expecting a risk premium on their investment for their added exposure to exchange rate risk. The possible reasons for this could be inadequate hedging by firms for the exchange rate risk and in the larger macroeconomic sense, it displays markets inefficiencies in the stock market and/or foreign exchange market since Arbitrage Pricing Theory suggests that only systematic risks should be priced by capital markets.