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The Effects of Financial Leverage Changes on Stock Returns: A Study of Exchange Rate Volatility

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Abstract

This essay aims to discuss the changes of capital structure toward stock returns and return on assets, with a further introduction of interference factors of exchange rate risks. The correlational changes of both factors would be analyzed in terms of different fluctuation levels. The empirical results show significant discoveries: both the factors have positive correlations. Reasons can be deduced from the willingness of trading firms, the company operational requirements, and the psychology of return expectation. Thus, this study suggests the investors to include exchange rate fluctuation index, while the government shall timely open up to corporate transactions and the corporate should carry out overall exchange rate and interest rate hedging.

Keywords: Capital structures, financial leverages, free cash flows, stock returns, foreign exchanges, interest rates.

1. Introduction

Since the subprime mortgage crisis in 2006 and the financial crisis in 2008, with the aim to boost the economy by increasing the willingness of investment and private consumption as well as decreasing investment cost and unemployment rate, quantitative easing (QE) was implemented. The Federal Reserve (FED) has injected a large amount of money into the market for which the US interest rate raised 13 times and fell 17 times from 2000 to 2014, while the FED base rate fell 0.25% from 6.5%, resulting into USD/NTD exchange rate from 32.99 in 2000 to 31.72 in 2014. Given the fact that there has been no significant improvement in the US economy, the FED would continue injecting funds so that the deposit and lending rates dropped to historic new lows, or even zero deposit rate. It was intended to force the flow of funds into investments and consumptions via monetary policy as to raise economic growth rate and reduce unemployment rate; therefore, there are too much idle funds in the market and less loan lending from the financial institutions.

Since the reform in 1989, China's economic growth rate has been growing with a speedy rate of more than 10% every year. After years of trade surplus, a large amount of