



Invited Article

Foreign investment and real exchange rate volatility in emerging Asian countries



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ABSTRACT

This study asks whether greater foreign investment reduces real exchange rate volatility in eight emerging Asian countries. As a noteworthy aspect, we utilize detailed measures of foreign investment, including foreign direct investment, foreign portfolio equity, and foreign debt. Our findings from both time-series and panel data for the period 1980–2011 indicate that greater stocks of foreign liabilities reduced real exchange rate volatility for China, India, Malaysia, Singapore, and South Korea but increased real exchange rate volatility for Indonesia, the Philippines, and Thailand. We further examine the effects of several important factors on real exchange rate volatility for the two groups of countries separately.

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1. Introduction

This study investigates the impact of greater foreign investment on the receiving country's real exchange rate volatility for eight emerging Asian economies over the period 1980–2011. The literature offers mixed views on how greater foreign investment affects real exchange rate volatility. On the one hand, the abolition of exchange controls and the resulting increase in foreign investment (particularly short-term) may amplify the impact of shocks to the economy and may also cause abrupt reversals, which generate undesired volatility in both the real exchange rate and real economy (Corden, 2002; Reinhart & Smith, 2002). On the other hand, greater foreign investment may reduce real exchange rate volatility by increasing liquidity, improving factor productivity, and stabilizing domestic consumption and investment spending through international risk-sharing (Agénor, 2003). In particular, greater foreign investment can improve risk-sharing by tying rates of return on external liabilities to domestic macroeconomic conditions (Aguirre & Calderón, 2005; Le Fort, 2000). For a panel of emerging Asian countries, Jongwanich and Kohpaiboon (2013) and Athukorala and Rajapatirana (2003) find different forms of foreign investment have different impacts on real exchange rates. As such, it is not only the size, but also the composition of foreign investment that can play a critical role.

This study contributes to the literature in a number of ways. First, existing research has largely focused on analyzing the impact of real exchange rate volatility on foreign (direct) investment, with very limited attention to the reverse relationship.

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Our attempt is to narrow this gap, since evidence suggests that greater real exchange rate volatility (especially in developing countries) can adversely affect economic growth, capital movements, and international trade (Hviding, Nowak, & Ricci, 2004). In addition, major real exchange rate depreciations can cause severe balance sheet problems including default on external debt (Prasad, Rogoff, Wei, & Kose, 2003). Second, existing studies analyze the impact of aggregate capital inflows on the real exchange rate. We utilize, instead, stocks of foreign investment.² As discussed by Kose, Prasad, Rogoff, and Wei (2009), the use of stocks is preferable, since capital flows tend to be more volatile and prone to measurement error. Third, in line with Jongwanich and Kohpaiboon (2013) and Athukorala and Rajapatirana (2003), we utilize detailed measures of foreign investment, including foreign direct investment, foreign portfolio equity, and foreign debt. Foreign direct investment refers to direct investment in a domestic company, giving the foreign investor an ownership share. Portfolio equity holdings refer to foreign investors' purchases of domestically-issued equity in a company. The debt category includes foreign investors' purchases of debt issued by domestic companies or the government, and also foreign borrowing undertaken by domestic banks and other debt instruments. It is important to separately consider these subcategories of foreign investment as they may differ in the risk-sharing properties of their returns (Milesi-Ferretti & Razin, 1996). Fourth, unlike existing studies which employ only panel data, we utilize both individual-country time-series and panel data in estimation. Specifically, we first estimate our model with individual-country time-series data and then use the results to appropriately group the countries for panel estimation.

Our sample consists of eight emerging Asian countries including China, India, Indonesia, Malaysia, the Philippines, Singapore, South Korea, and Thailand. These countries have been among the world's top 20 host countries of foreign investment in the last two decades with foreign direct investment (FDI) inflows averaging 20% of global FDI (UNCTAD, 2013). While major debtors (such as the US) have increasingly relied on debt as a source of external finance, these emerging market countries have increased the equity component in their external assets and liabilities and have also accumulated significant official reserves over the last two decades. Despite their move towards more open markets and liberalized investment environments, these countries are still in the early stages of financial globalization. As such, they face numerous ongoing decisions about the timing and pace of hosting more foreign investment and maintaining their export competitiveness. Another important factor for choosing these emerging countries is their strong economic fundamentals and healthy financial institutions which allowed them to recover faster than other regions from the recent global financial crisis (Jongwanich & Kohpaiboon, 2013). Further, the variations in the pattern and composition of foreign investment in these countries are particularly important in determining the impact of foreign investment on real exchange rate volatility. Fig. 1 highlights the relative importance of FDI to other forms of foreign investment in the eight countries for the period 1980–2011.

Our estimation results using individual-country time-series data indicate that greater FDI was more effective in reducing real exchange rate volatility for China, India, Malaysia, Singapore, and South Korea. For Indonesia, the Philippines, and Thailand, greater FDI, in particular, increased real exchange rate volatility. These findings are confirmed by the panel estimation results. We proceed with a literature review in Section 2. Section 3 discusses the data, methodology, and empirical results. Section 4 examines the effect on real exchange rate volatility of such important factors as the degree of financial development, fiscal policy, inflation volatility (as a proxy for macroeconomic stability and institutional quality), the level of official foreign asset reserves, and monetary policy. Section 5 concludes.

2. Related literature

The literature suggests that greater foreign investment can lead to financial and macroeconomic stability through consumption smoothing, increasing liquidity, improving factor productivity, and promoting domestic investment (Agénor, 2003). A number of studies further suggest that the potential benefits of foreign investment are indirect and work through improvements in structural, institutional, and macroeconomic policy variables (Kose et al., 2009; Lane & Milesi-Ferretti, 2004). Greater foreign investment allows the country to borrow in bad times and lend in good times, lowering fluctuations in consumer demand. By alleviating problems caused by the low saving rate in some developing countries, greater foreign investment can increase physical capital per worker and thus improve both national income and the standard of living. Greater foreign investment may also accelerate both the development and efficiency of domestic financial markets, resulting in higher factor productivity (Levine, 2001). In particular, increasing the number of foreign banks in the domestic economy improves the quality and availability of financial services. It also contributes to stability of the domestic financial system by providing depositors with alternative deposit havens inside the country, thus discouraging capital flight through the transfer of assets abroad. Goldstein and Turner (2004) argue that countries which can attract more foreign investment are better able to face the challenges of financial globalization. Obstfeld (1998) notes that, in an effort to attract more foreign investment, countries adopt more disciplined macroeconomic policies by reducing the frequency of policy mistakes.

Compared to other forms of foreign investment, the potential benefits from FDI are expected to be larger in terms of reducing real exchange rate volatility. Markusen and Venables (1999) suggest that FDI increases the degree of competition and integration in both products and factors markets. As pointed out by Hull and Tesar (2001), capital inflows generate increased demand for both tradables and nontradables and lead to a higher relative price of nontradables and real

² To the best of our knowledge, no study to date has analyzed the impact of stocks of foreign investment on real exchange rate volatility for Asian countries.

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