

## **THE ADVERSE EFFECTS OF REAL EXCHANGE RATE VARIABILITY IN LATIN AMERICA AND THE CARIBBEAN**

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The paper examines the pros and cons of anticipated appreciation and the asymmetric effects of short-term exchange rate fluctuations in a sample of countries in Latin America and the Caribbean. On the demand side, exchange rate depreciation increases competitiveness and export growth, expanding output growth. On the supply side, depreciation increases the cost of imported inputs, increasing output capacity constraints and accelerating price inflation. The time-series evidence indicates that output expansion (contraction) and price deflation (inflation) predominate with anticipated currency appreciation (depreciation). The cross-country results show that exchange rate variability exacerbates the variability of economic activity across countries. Short-term fluctuations of the exchange rate may reflect the adverse effects of unanticipated currency fluctuations. Therefore, more flexibility towards aligning the real effective exchange rate with the underlying fundamentals could help mitigate the adverse effects of higher cost of imports and loss of competitiveness on real growth, and ease inflationary pressures.

*JEL classification codes:* F1, F4

*Key words:* exchange rate, supply and demand channels, asymmetric fluctuations

### **I. Introduction**

Recent developments in the world economy have drawn attention to the appropriate exchange rate policy in developing countries. Many of these countries have opted to peg their exchange rate to the US dollar to hedge against inflationary pressure in light of their exposure to frequent external shocks and inadequate monetary instruments for liquidity management. Continued fluctuations in the US dollar relative to other major currencies have increased the risk of a pegged

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exchange rate and exposed countries to frequent inflationary pressures and loss of competitiveness. Accordingly, many of these countries have considered revising their exchange rate policy to establish a weighted scheme for the peg, reflecting major shares of significant trading partners.

The traditional view has emphasized the expansionary effect of currency depreciation (see, e.g., Meade 1951). The Marshall-Lerner condition states that devaluation will improve the trade balance if the devaluing nation's demand elasticity for imports plus the foreign demand elasticity for the nation's exports exceed one (see Hirschman 1949). By lowering export prices, currency depreciation helps export competitiveness towards boosting real growth. Through the supply side channel, depreciation may result in higher cost of intermediate goods for production in developing countries (see, e.g., Bruno 1979 and van Wijnbergen 1989). Domestic substitutes for imported production inputs, particularly capital goods, are not readily available in many developing countries. As a result, the output supply may shrink on account of a higher cost of imported inputs. The net result on real output and price will depend on the magnitudes by which the demand and supply curves shift following devaluation (for details, see Gylfason and Schmid 1983 and Lizondo and Montiel 1989).<sup>1</sup>

Currency depreciation from an initial trade deficit could lead to further deterioration by reducing aggregate demand and, therefore, real national income. A larger trade deficit signifies high dependency on imports that would reinforce the negative effect of currency depreciation on the output supply and raise price inflation. However, if trade is in balance and terms of trade are not changed, price changes in response to currency depreciation would offset each other through the export and import channels (see Cooper 1971).

Other studies have illustrated alternative channels for contraction following currency devaluation. By increasing relative competitiveness, depreciation may raise the windfall profits in export and import-competing industries. If money wages lag the price increase and if the marginal propensity to save from profits is higher than from wages, national savings would go up and real output would

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<sup>1</sup> Hanson (1983) provides theoretical evidence that the effect of currency depreciation on output depends on the assumptions regarding the labor market. Solimano (1986) studies the effect of devaluation by focusing on the structure of the trade sector. Agenor (1991) introduces a theoretical model for a small open economy and distinguishes between anticipated and unanticipated movement in the exchange rate. Examples of empirical investigations include Edwards (1986), Gylfason and Radetzki (1991), Rogers and Wang (1995), Hoffmaister and Vegh (1996), Bahmani (1991), and Kamin and Rogers (2000).

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