



Capital flows, exchange rate flexibility, and the real exchange rate

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ABSTRACT

This paper first analyzes the impact of capital inflows on the real effective exchange rate for a sample of 42 emerging and developing countries over the period 1980–2006. The results from the pooled mean group estimator show that both public and private inflows are associated with an appreciation of the real effective exchange rate. Among private inflows, portfolio investments display the biggest impact on the appreciation – almost seven times that of foreign direct investment or bank loans – while private transfers have the smallest effect. The paper also shows that a more flexible exchange rate regime, measured by different indicators, could effectively dampen the real appreciation associated with capital inflows, supporting countries' competitiveness.

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1. Introduction

Policy maker often seek to attract external financing to cover savings–investment gaps and to promote growth and economic development (Dornbusch, 1998). Their strategy can be implemented through the openness of the capital account, although over the last decade the benefit of this openness has become a controversial issue (Kose et al., 2006). A significant increase in capital inflows could, for instance, weaken the financial system by exacerbating maturity and currency mismatches between banks' assets and their liabilities. Large capital inflows could also push the real effective exchange rate (REER) above its long-run equilibrium level, weakening countries' competitiveness (Calvo et al., 1993; Agenor, 1998). The analysis of the surge of external financing, especially private flows, and the potential impact of the so-called “transfer problem” on the real effective exchange rate (REER) of developing economies is the focus of this paper.

Private flows to emerging and developing economies have steadily increased since the 1980s, while public flows have decreased. For the sample of 42 countries we consider,² private flows swelled from less than 2% of GDP in the early 1980s to in excess of 6% in 2005/6. This increase is even more dramatic for low-income countries, where private flows jumped from 1.5% to almost 10% of GDP during the same period. This spectacular rise in private flows was driven by foreign direct investment (FDI), current private transfers (mainly remittances), and portfolio investment, which substituted for commercial bank loans as the main components of private flows after 1990. Such changes underline the importance of reassessing what some authors

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² The appendix provides the list of these economies.

refer to as the “transfer problem.” With most studies exploring the effect of aggregated capital inflows on the REER, this paper contributes to the literature by analyzing the reasons why different components of private flows (FDI, portfolio investment, bank loans, and private transfers) impact the REER differently. In addition, as various macroeconomic tools can be used to dampen the REER appreciation effect of capital inflows (IMF, 2007), we also explore how the flexibility of the exchange rate may modify this outcome.

The analysis uses a sample of 42 countries over the period 1980–2006. The pooled mean group estimator is adopted, allowing short-run heterogeneity while imposing long-run homogeneity on the REER determination across countries. The results show that public and private capital inflows are positively correlated with an appreciation of the REER that may conflict with the competitiveness of the economy. Among private flows, portfolio investments have the biggest appreciation affect – almost seven times that of FDI or bank loans – while private transfers have the smallest effect. Furthermore, *de facto* measures of exchange rate flexibility suggest that a more flexible exchange rate could effectively dampen the real appreciation associated with capital inflows.

The rest of this paper is organized as follows. Section 2 stresses potential heterogeneity on how different types of capital flows would affect the REER. This section also discusses the role played by the exchange rate regime. Section 3 presents the econometric model. Section 4 analyzes the results and provides some robustness checks. Section 5 concludes.

2. Composition of capital inflows, exchange rate regime, and the real effective exchange rate

Capital inflows potentially increase demand for both tradables and non-tradables, leading to higher relative price of non-tradables, in other words, the appreciation of the REER. Domestic resources are then diverted to production of non-tradables to meet the increased demand. This phenomenon must be qualified for at least two reasons: (1) the REER can be affected differently depending on the composition of capital inflows; (2) the type of exchange rate regime may sway the effect of capital inflows on the REER.

2.1. Composition of capital inflows and the REER

The literature provides mixed evidence on the effect of capital flows on the REER. The impact of official inflows mainly depends on how the resources are used. Some authors, following the pioneering work of Elbadawi and Soto (1994), have recently, with mixed results, hypothesized specific impacts of capital components such as aid – the main capital inflow of most developing countries until the 1990s – but also FDI, portfolio and short term capital movements, as well as remittances that have the dimension of financial transfers.

Official flows generally tend to be associated with an appreciation of the real exchange rate, although not all studies are conclusive on this point (Hussain et al., 2009). In Cerra et al. (2008), foreign aid goes hand in hand with a real exchange rate appreciation only if it enhances productivity in the tradable sector. Where foreign aid is channeled to improve the productive capacity in the non-tradable sector, the authors find evidence of depreciation. The impact of official flows on the real exchange rate depends on how resources are used. In the context of supply constraints, capital inflows that are associated with higher consumption put more pressure on the relative price of domestic goods than capital inflows that are associated with higher investments and a significant content of imported goods.³

FDI can be related to imported machinery and equipment. In this case, not only there is there no presumption of an appreciation effect, but a positive effect may exist through productivity gains, resulting from transfers of technology, managerial know-how, or other intangible assets (Agenor, 1998; Javorcik, 2004; Kinda, 2012). However, FDI may also consist of pure transfers of domestic assets between residents and non-residents, as illustrated by some national privatization programs. The one-off revenues or bonanza resulting from the selling of public enterprises can be channeled to permanent current expenditures, increasing the price of non-tradable and, consequently, real exchange rate disequilibria.

The impact of short-term inflows on the REER is by far the most debated issue. Commercial bank loans and international portfolio investments can be speculative flows, not related to domestic productivity improvement, and associated with REER appreciation (Elbadawi and Soto, 1997). However, for some countries, especially those where the capital account has been liberalized, these variables may have a trend, or be part of a long run cycle generating real appreciations and then exchange rate disequilibria. This effect potentially extends to all kinds of short-run inflows, as these transactions are intermediated by domestic banks.

Remittances resulting from international transfers can be assimilated to private capital inflows; their influence on the real exchange rate mainly depends on whether they are pro- or countercyclical. Indeed, remittances may act as a buffer, helping to smooth consumption, if they increase when the recipient economy is suffering an economic downturn (Chami et al., 2008). In this case they help to keep recipient economies stable by compensating for foreign exchange losses due to macroeconomic shocks. These countercyclical remittances do not have much effect on the real exchange rate. But remittances may also be mobilized for investment purposes with a procyclical effect. If they are spent on imported consumer durables they have little impact on the REER (Chami et al., 2008). But they can also exacerbate domestic overheating and drive the real

³ The structure of consumption also influences its effect on the real exchange rate: A larger share of traded goods in public or private consumption affects the real exchange rate differently.

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