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Financial Flows Can Create Exchange Rate Issues

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Developing countries have been receiving increasing amounts of finance-related flows, which are also becoming more volatile —two features that increase the importance of such flows in determining exchange rates. This process is part of broader changes in the relationship between the 'financial' and the 'real' sectors, characterised by the increasing importance of financial assets and motives. These changes have been referred to as financialisation.

A core policy that allowed the emergence of this process was the broad implementation of policies to liberalise capital accounts. In addition to this policy decision, other developments also played a crucial role, such as improvements in communications and information technology and the emergence of investment funds —which play a major role for being so few in number —which trade very large amounts of capital among several countries.

Studies on the consequences of financialisation are recent and relatively scarce, but the consequences of capital account liberalisation have been well analysed, revealing that this policy had worse results in developing countries than in developed ones. Indeed, these countries have suffered from different episodes of sudden capital outflows, which were triggered not only by issues in their domestic economies but also in other recipients of capital flows and in 'funding' economies. The impacts of liberalisation on developing countries can be associated with the specificities of these countries' entry into the international monetary system and with the different effects of exchange rates in these countries (Ramos, 2012).

The international monetary system is characterised by a hierarchy of currencies, where the ones used in international trade and as a reserve of value are the most liquid. As more liquid assets are preferred in periods of higher uncertainty, when it is more difficult for agents to assess their expectations about the return of an asset, capital flows to developing countries only in periods of high international liquidity; otherwise it flows out.

Developing countries can face policy challenges in these two different periods. In a long period of high international liquidity, developing countries might receive significant amounts of capital flows, which leads to an exchange rate appreciation that might become an exchange rate misalignment. In periods of high risk aversion, developing countries will face significant volatility of flows, which translates into volatility of the exchange rate. These two exchange rate issues —misalignment and volatility— are major issues for both developed and developing countries, but their impact can be amplified in developing countries due to their specific circumstances.

The importance of the exchange rate lies in its major role in determining the competitiveness of a domestically produced good. Thus, the exchange rate has significant impacts on the level and on the composition of international trade and, therefore, also on the productive structure and employment. This is even more important for developing countries, where competitiveness is mainly price-driven. A change in the exchange rate also affects inflation; this is especially important in developing countries, where the exchange rate pass-through to inflation is higher.

As a consequence of these multiple links through which the exchange rate affects the real economy, its instability has a notable effect on the level of uncertainty of its economic agents, harming fixed investments. Exchange rate volatility can also have important effects in developing countries in the case of currency mismatch— which is common due to their difficulties in issuing debt in their own currencies.

With regards to misalignment, although its definition and measurement are subject to considerable debate, there is a consensus on the use of the concept to indicate an exchange rate that does not reflect a country's fundamentals. Some features of the financial capital flows and of their relationship with a country's currency might indicate whether a process leading to exchange rate appreciation or depreciation resulted in misalignment. One of these features is the importance of push factors in determining capital flows— which could be examined, for instance, by the path of peer countries' currencies.

Another feature is the cyclicality of portfolio flows themselves. This would happen if foreign investors expected a currency appreciation to continue and saw a possibility of higher returns with an investment in the country—thus increasing the capital inflows, which feeds back to more appreciation. An exchange rate misalignment has important consequences in an economy. An over-appreciation can affect the economic structure in a Dutch disease style, and an undervaluation might be a misleading incentive for assuming risks related to external debt.

Thus, the increased weight of finance-related flows in determining exchange rates and the specific dynamic of these flows to developing countries intensified problems of exchange rate volatility and misalignment. These have had significant negative effects on emerging developing countries, which are cycle takers and the recipients of significant and volatile finance-related flows.

Reference:

Ramos, R.A. (2012). 'Financial Flows and Exchange Rates: Challenges Faced by Developing Countries', *IPC-IG Working Paper No. 97*. Brasília, IPC-IG.

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