Empirical Analysis of the Capital Inflows and Real Exchange Rate Nexus in Developing Countries

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Abstract:

Despite potentially growth-enhancing benefits, capital inflows carry the risk of real exchange rate appreciation that could reduce the competitiveness of the capital-recipient country's export industries; thereby jeopardizing macroeconomic stability and economic growth in developing countries. Against this backdrop, this study empirically investigates the impacts of capital inflows on real exchange rate for a sample of 113 developing countries from 1991-2015. The study employs the two-step system generalized method of moment technique to estimate dynamic panel data models. The results show that the increase in gross capital inflows causes real exchange rate appreciation. When the gross capital inflows are disaggregated into foreign direct investments (FDI) and non-FDI, only the FDI causally appreciate the real exchange rate. However, the empirical results also show that the improved mobilization and allocation of financial resources help reduce the exchange rate appreciation effects of the capital inflows. The findings are highly relevant for policymakers, particularly in developing countries, who are gravely concerned with the rising capital inflows. The study suggests that financial sector development plays a crucial role to help dampen the real exchange rate appreciation impacts of capital inflows in developing countries.

Keywords: Capital inflows, real exchange rate, system generalized method of moments, developing countries

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