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The Impact of G-3 Exchange Rate Volatility on Developing Countries

Gerardo Esquivel and Felipe Larraín B.

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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s.* Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series.*

The Project of Technical Support to the G-24 receives generous financial support from the International Development Research Centre of Canada and the Governments of Denmark and the Netherlands, as well as contributions from the countries participating in the meetings of the G-24.

THE IMPACT OF G-3 EXCHANGE RATE VOLATILITY ON DEVELOPING COUNTRIES

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Abstract

This paper describes G-3 exchange rate volatility and evaluates its impact on developing countries. The paper presents empirical evidence showing that G-3 exchange rate volatility has a robust and significantly negative impact on developing countries' exports. A one percentage point increase in G-3 exchange rate volatility decreases real exports of developing countries by about 2 per cent, on average. G-3 exchange rate volatility also appears to have a negative influence on foreign direct investment to certain regions, and increases the probability of occurrence of exchange rate crises in developing countries. These results imply that greater stability in the international exchange rate system would help improve trade and foreign direct investment prospects for developing countries – and would help prevent currency crises.

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THE IMPACT OF G-3 EXCHANGE RATE VOLATILITY ON DEVELOPING COUNTRIES

Gerardo Esquivel and Felipe Larraín B.[*]

I. Introduction

There is a widespread presumption that volatility on the exchange rates of developed countries is one of the main sources of economic instability around the world. For example, an influential group of people which includes, among others, Paul Volcker and George Soros, has recently stated that "… the impact of the global economy on emerging countries is driven significantly by swings among the currencies of the three major economic powers. In recent years these swings have been enormous, volatile and frequently unrelated to underlying economic fundamentals. … The current G-3 authorities intervene on a totally ad hoc and episodic basis, without any clear sense of a sustainable equilibrium. Such intervention typically comes too late to prevent severe als that generate a second round of large costs." (Allaire et al., 1999).

These criticisms are not new. In fact, the exchange rate arrangement that emerged after the collapse of Bretton-Woods has always been criticized on the grounds that it does not have a mechanism to reduce or regulate excessive exchange rate fluctuations among the major currencies.[1] More recently, it has also been argued that G-3 currency instability[2] may have been at the root of some of the currency and financial crises that have affected several developing countries. A prominent example in this regard is the Asian crisis of 1997 which, for many authors, was partly due to the strong appreciation of the dollar vis-à-vis the yen that took place between mid-1995 and 1998.[3]

As a consequence, there is renewed interest on