Untersuchungen zur Wirtschaftspolitik [U 134]

Exchange Rate Uncertainty, Investment and International Trade Empirical Evidence from Selected Latin American Countries

Von *Bianca Clausen*

Increased financial integration and a rise in international trade flows in the last thirty years have directed considerable attention to the effects of exchange rate developments on macroeconomic variables. The rise in global integration has brought about an increase in the volatility of real exchange rates and has also magnified uncertainty about the future path of these rates. As an increase in real exchange rate uncertainty may have a direct adverse effect on macroeconomic variables such as investment and international trade, it may ultimately reduce economic growth rates. These effects may be particularly pronounced in emerging economies as they exhibit levels of real exchange rate uncertainty that are far larger than those experienced in developed economies.

This study contributes to the discussion on the effects of exchange rate uncertainty on economic development by conducting an empirical analysis for six Latin American countries: Brazil, Chile, Colombia, Ecuador, Mexico, and Peru. More specifically, it analyzes the effects of real exchange rate uncertainty on aggregate investment and international trade, two variables that have a significant impact on economic growth and development. In addition, this study discusses the effects of different exchange rate regimes on the level of exchange rate uncertainty. It investigates the claim that the stability provided by fixed exchange rate regimes is conducive to sustainable economic growth, in particular to increased levels of investment and foreign trade. In contrast to many existing studies on these subjects, this study provides unambiguous results. When accounting for threshold effects, above average levels of real effective exchange rate uncertainty have a detrimental effect on aggregate investment in all countries in the sample. In addition, above average levels of bilateral real exchange rate uncertainty have a significantly negative effect on both real imports from and real exports to the United States. Furthermore, the analysis cannot confirm the argument that floating exchange rate regimes are associated with higher degrees of real effective exchange rate uncertainty. Instead intermediate exchange rate regimes exhibit the highest level of real effective exchange rate uncertainty both within and across countries. Therefore, the negative effects of exchange rate uncertainty on investment and foreign trade that was the result of the empirical part of this study does not justify the introduction of fixed exchange rate regimes.

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Bianca Clausen: Exchange Rate Uncertainty, Investment and International Trade Empirical Evidence from Selected Latin American Countries
Köln 2009. 254 Seiten
ISBN-13: 978-3-933812-22-3 € 35,-