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Disentangling the exchange rate risk, sectoral export flows and financial development nexus

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Since the breakdown of the Bretton Woods international monetary international currencies have been particularly volatile. This volatility in the relative value of international currencies holds especially true for the currencies of emerging market economies. These economies are arguably more susceptible to the probable negative macroeconomic effects resulting from speculative attacks on their respective currencies than developed market economies. Emerging markets are not characterised as having adequate financial markets and macroeconomic institutions conducive of stability. Nevertheless, exactly what the negative macroeconomic effects could be – if any – has been the subject of considerable empirical scrutiny since the 1980s. Of particular concern to international economists have been to examine what the potential effect of exchange rate volatility could be on global welfare and international trade flows. While the volume of research has been substantial, empirical research has thus far been unable to reach consensus surrounding the conjectured effect that exchange rate volatility may exert on international trade flows. After the subprime mortgage crisis of 2007 to 2009, the Great Recession of 2008 to 2012 and with several European countries still reeling from the sovereign debt crisis, emerging market currencies have seen great fluctuations in value over the last couple of years.

Discerning what the effect of volatility of emerging market currencies may be on international trade flows is of great importance to domestic policymakers. Such information would provide policymakers with the impetus to pursue policies conducive of macroeconomic stability. Moreover, given the sectoral focus of this study, results obtained here may serve as motivation for targeted sectoral policies to support certain emerging market export sectors during periods of volatility. It is the objective of this study to determine the effect that exchange rate risk – measured as exchange rate volatility – exerts on the sectoral export flows of selected emerging market economies. Additionally, whether financial development is able to both support export flows as well as mitigate the hypothesised significant negative effect of exchange rate risk is also analysed. This study subjects the sectoral export flows of eleven emerging market economies (including South Africa) over the quarterly nine-year period ranging from 2007 until 2015 to analysis. Panel data regression analysis is the preferred empirical method given its several advantages over conventional time-series analysis. The general findings of this study allows for the conclusion that exchange rate risk does not exert a uniform effect across various emerging market export sectors in terms of size, direction and statistical significance. Empirical results of this study suggest that differentiated export product lines may be more susceptible to exchange rate risk. However, this negative effect is not prominent across all differentiated export product sectors considered. With regards to financial development, across all exchange rate risk proxies and estimators employed, the size and significance of the financial development proxy fluctuates considerably. This finding would suggest that the sectoral

exports of emerging market economies are not particularly significantly impacted by the level of financial development.

The findings and conclusions of this study alluded to above are of importance in formulating possible policy frameworks with which to curb the potential negative impacts of exchange rate risk. With regards to macroeconomic policy, it is advised that monetary policy authorities in emerging market economies adopt policy frameworks with which to inspire stability and circumventing speculative currency attacks. Such a framework would entail maintaining a strict intention on the part of monetary authorities to inspire stability by following monetary policy rules through the employment of appropriate monetary policy tools. Additionally, when compared to developed market economies, emerging markets do not have such a large number of its own multinational corporations. Encouraging such corporations – especially for differentiated goods producers – to invest abroad in additional manufacturing plants would diversify the risk of loss in revenue caused by volatile exchange rates. Reducing barriers that could exist that prohibits emerging market investment abroad should be the first course of action. With regards to the impact exerted by exchange rate risk on sectoral export flows more focused policy frameworks are required. Since it was found that differentiated export sectors may be more susceptible to exchange rate risk when compared to homogeneous goods, exporters in these sectors should be cautious during periods of volatility and attempt to find ways in mitigating the potential negative impact that exchange rate risk could exert on the level of export flows from these sectors. While the intermediate levels of financial development in emerging market economies may not be as supportive of export flows, existing empirical evidence does suggest that the exports of countries with highly developed financial markets are buoyed by financial services and institutions, financial development is able to mitigate some of the negative impact exerted by exchange rate risk on emerging market export flows. For this reason, emerging market authorities ought to advance policies promoting the development of financial services in the form of credit availability, and sound and stable financial market institutions. Such advancement in the countries' financial systems is expected to improve the availability of novel and more effect financial instruments with which to hedge the potential negative effect of exchange rate risk on the exports of differentiated export sectors.