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ORIGINAL ARTICLE

Exchange rate volatility and capital inflows: role of financial development

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Abstract There is vast literature examining the impact of exchange rate volatility on various macroeconomic aggregates such as economic growth, trade flows, domestic investment, and more recently capital flows. However, these studies have ignored the role of financial development while examining the impact of exchange rate volatility on capital flows. This study aims to analyze the impact of exchange rate volatility on capital inflows towards developing countries by incorporating the role of financial development over the time period 1980–2013. In this regard, the behavior of two types of capital flows is examined: physical capital inflows measured as foreign direct investment, and financial inflows quantified through remittance inflows. The empirical investigation comprises the direct as well as indirect effect of exchange rate volatility on capital inflows. The study employs dynamic system GMM estimation technique to empirically estimate the effect of exchange rate volatility on capital inflows. The empirical results of the study identify that exchange rate volatility dampens both physical and financial inflows towards developing countries. The indirect impact of exchange rate volatility through financial development, however, turns out positive and statistically significant. This finding reflects that financial development helps in reducing the harmful impact of exchange rate volatility on capital inflows. Hence, the study concludes that a developed financial system is an important channel through which developing countries may improve capital inflows in the long run.

Keywords Capital inflows · Foreign direct investment · Remittances · Financial development · Exchange rate volatility

JEL classification F310 · F41 · F24

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