Foreign Exchange Constraint and Developing Economies

Edited by Aleksandr V. Gevorkyan

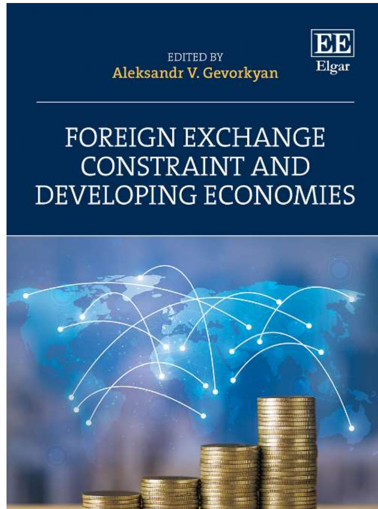
Book Review Contributed by Nicholas A.J. Landis

February 6, 2024

The Central Bank of Barbados Book Review Series seeks to highlight publications which offer useful insights and analysis on topics related to finance, economic development, and other issues relevant to small island developing economies. The views expressed are those of the author(s) and do not necessarily represent those of the Central Bank of Barbados, its Board of Directors or Central Bank of Barbados management.

A Book Review of "Foreign Exchange Constraint and Developing Economies"

Edited by Aleksandr V. Gevorkyan



Publisher: Edward Elgar Publishing (2023)

ISBNS Cased: 978 1 80088 049 8

ISBN eBook: 978 1 80088 050 4

Book Reviewed by Nicholas A.J. Landis[1]

[1] Nicholas A.J. Landis, Research Officer, Central Bank of Barbados, Tom Adams Financial Centre, Spry Street, Bridgetown, Barbados.

Email: Nicholas.Landis@centralbank.org.bb

A Review of “Foreign Exchange Constraint and Developing Economies”

Edited by Aleksandr V. Gevorkyan

Developing economies are seeking to sustainably grow and improve the standard of living of their populations by utilising domestic and foreign resources in their production and consumption functions. Foreign exchange is at the centre of this process and flows as the lifeblood of small, open economies. The history of development within Latin America and Caribbean (LAC) is inextricably linked to globalisation with ubiquitous migration and transnational resource sharing. Foreign exchange acts as the transmission mechanism for resource sharing, and its relative scarcity or inefficient usage can be detrimental to the development of these economies.

Access to foreign resources exposes countries to the events that affect the price of those resources – such as oil, wheat, and many other commodities as well as factors of production. External shocks emanating from engagement in foreign trade pass through to the domestic market, whereby foreign problems become domestic problems. In fact, the two largest crises that negatively impacted GDP growth for LAC in the past 60 years occurred in 2009 (from the onslaught of the Global Financial Crisis - GFC) and 2020 (the COVID-19 pandemic), both caused by external shocks from global events.[2] The book “Foreign Exchange Constraint and Developing Economies”, edited by Aleksandr V. Gevorkyan, examines the usage of foreign exchange across emerging markets and explores issues surrounding capital structure, sustainable economic development, foreign exchange reserves, exchange rates, and crises stemming from external vulnerabilities.

The text is sectioned into eleven chapters, structurally encompassed by three main parts: 1) international capital markets; 2) currency valuations and exchange rate dynamics and 3) pandemic-induced international economy trends which are examined through the lens of a complex mix of developing economies’ realities.

The editor starts by introducing capital scarcity within the Caucasus and Central Asian (CCA) countries as well as Caribbean countries which majorly exhibit illiquid and underdeveloped national financial systems,[3] discouraging investment into the respective country’s capital market. The issue of capital scarcity is predominant among emerging economies, due to their underdeveloped domestic stock and bond exchanges (Coeurdacier et al., 2019). Stock exchanges, even where established, are often only

---

[2] GDP Data selected from World Bank (https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=ZJ).

[3] CCA countries include Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Turkmenistan, Tajikistan, and Uzbekistan.

newly formed or have only a few member companies with little trading activity, limiting their ability to provide access to capital for local firms. On the other hand, local-currency bond markets may typically lack investor confidence and have virtually no foreign investor participation. The higher risks of devaluations and debt restructurings existent in emerging countries invoke higher risks to domestic investors which makes their bonds even less appealing. Ultimately, this leads to a reliance on foreign capital sources (facilitated by cross-border liquidity), which in the case of foreign debt, leads to costly debt service charges and heightened pressure on foreign exchange levels.

Eichengreen, Hausmann, & Panizza, (2003) further argue that foreign debt capital dependence exposes governments to exchange-rate risk, as state revenues accrue in local currency but amortisation payments must be made in foreign currency. This leads to the development of a repayment problem referred to as the "original sin" – where countries borrowing in foreign exchange suffer from an increased debt service burden resultant from currency depreciation. On the firm level, if the collateral is denominated in local currency, currency depreciation will cause this asset to lose relative value and the mismatch may cause the firm to purchase currency to balance its accounts (to regain collateral levels established in the debt document). Dependent on the size and importance of the firm, and the number of similarly behaving firms, this may exacerbate devaluation pressures on the exchange rate. Overall, countries engaging in external debt acquisition will require larger primary balances to finance the debt service burden as well as increased foreign reserves to match its foreign exchange demands. Stable foreign capital flows are imperative to economic development and are crucial for augmenting capital stock and enhancing current account sustainability.

Emerging economies derive most of their foreign exchange from exports of primary resources (such as extraction of commodities), manufacturing products, and services (for example tourism) as well as inflows from foreign direct investment and foreign aid. As noted in chapter three, commodity exporters must be cognisant of the "Dutch disease effects" when engaging in international markets: booms in commodity prices (especially subsoil assets) could lead to exchange rate appreciation and resource movement towards extractive industries, shrinking the growth-inducing modern industrial sector. The economic sustainability arguments developed in this chapter state that each type of capital stock should be non-decreasing (strong argument) or total wealth should be non-decreasing (weak argument) to truly make progressive and inclusive economic development. As exemplified by Australia (Parker & Cox, 2020), the paradox of resources being a curse or blessing is mandated on the extractive industry's management, with Australia ranking highly in the world for income per capita (total wealth) but lowly in economic complexity (capital stock diversity).

The debt stock of the non-financial corporate sector in LAC increased by 42 percent between 2000-2009 and a further 225 percent between 2010-2020, as outlined in chapter four. Nevertheless, this extensive use of the international bond market did not increase investment; in reality, there was a 1.2 percent decline in the growth rate of fixed capital formation at both the aggregate and country levels between 2010 and 2020. Therefore, the high leveraging (and overleveraging on some cases) of these economies did not translate into growth, and countries became more at risk to banking crises. Poor debt sustainability practices were the likely culprit, as additional debt was not linked to growth enhancing activities, wasting valuable foreign exchange in unsustainable debt servicing.

Part II begins with an exploration of foreign exchange constraint and currency relationships (country demand for foreign exchange outstripping supply/reserves of international currencies). As outlined in chapter six, foreign exchange constraint besets developing economies and usually exposes a combination of external vulnerabilities: 1) low levels of international reserves and/or high levels of external debt; 2) large current account deficits; 3) short access to foreign finance. These vulnerabilities coupled with climate and health risks make developing countries a prime target of the foreign exchange constraint. Hence, the authors argue that countries should utilise balance-of-payments (BOP) strategies as well as industrial policies. Thirlwall's law states that countries can increase their BOP equilibrium rate by increasing exports and/or reducing income elasticity of demand for imports. This is viable by strategic export promotion and targeted import substitution in developing economies.

Essentially, foreign exchange reserves are paramount to sound BOP management and the smooth workings of a contemporary open economy. Chapter seven seeks to determine the optimal level of reserves for small open economies within the Caribbean using cost benefit analysis to determine trade equilibrium. This analysis is done by examining the insurance role of reserves (benefit from reducing the probability of crisis incidence and lessening its impact upon occurrence) and growth forgone (cost of reserves tied up rather than diverted to growth-enhancing public investment). From a risk-neutral standpoint, the optimal reserve level was estimated at 6.9 months of import cover and 5 months considering finance costs at 5 percent. Nonetheless, countries are generally risk-averse and certain factors would lead to more reserves being warranted: maintaining a currency peg, the level of foreign direct investment, level of external debt, and hurricane probabilities, to name a few. Interestingly, policies that reduce vulnerabilities were demonstrated to lower the need for reserves. In Barbados, the stock of gross international reserves culminated to $2.9 billion at September 2023, constituting 30.3

weeks (7 months) of import cover.[4] This level of import cover in excess of the suggested 5 to 6.9-month cover is justifiable by the need to maintain a currency peg, high external debt servicing, and the goal of providing investor confidence. The authors showed that within the Caribbean average international reserves stood at 2.96 months – considerably below the advised levels and hiking risks of large, unmitigated shocks. The sound management of foreign reserve availability is a crucial tool for achieving economic development in developing world (Blackman, 1976).

The ultimate part of this book explored crises and its effects on resource movement. Mounting liberation of resource movement in the world leads to small open economies losing quality human resources through emigration, to seek higher earnings abroad. However, when abroad, citizens of small open economies often send money to their home country in the form of remittances. This is a valuable source of foreign exchange and income for many countries. Lebanon is one such example shown in Chapter 11, receiving US$12.8 billion of remittances, which was equal to 12.7 percent of GDP in 2018. In the LAC, remittances are growing, reaching US$127.6 billion in 2021 (Maldonado & Harris, 2022). Remittances positively impacts the economy if the increase in foreign exchange liquidity overshadows the negative effects of brain drain on human capital development. However, a decreasing labour force participation rate can negatively affect growth if the benefits from remittances are not overwhelmingly positive.

The trend of ever-increasing globalisation grinded to a halt with lockdowns from the COVID-19 pandemic during 2020 and 2021. Small open economies faced the key challenges of devaluation pressures, massive closures of Micro, Small, and Medium Enterprises (MSMEs), growth of social and mental problems in the population, and BOP constraints (Abuselidze & Slobodianyk, 2020). A number of emerging markets responded by loosening fiscal policy, stabilising the economy and providing essential support to families during lockdown. This is contrary to prior individual crisis responses by the LAC, as their general policy decisions and frameworks moved in a countercyclical manner (as opposed to their often procyclical measures). Time will tell if this countercyclical strategy was an ideological paradigm shift within LAC or a temporary stance in line with the global concerted policy stance during the pandemic. The COVID-19 pandemic shock was a pronounced stress test on the resilience of small open economies to regulate their BOP and foreign exchange constraints. Capital flows to emerging market economies faced a shock deeper than at any point in the GFC.

[4] (https://www.centralbank.org.bb/news/economic-reviews/central-bank-of-barbados-review-of-the-barbados-economy-january-september-2023) Foreign reserves excerpt – Central Bank of Barbados Press Release.

As outlined in the penultimate chapter, a quantitative analysis of emerging market economies suggests that they are more likely than developed economies to undergo larger shocks (domestic and foreign) as their economies are smaller and less diversified which exacerbates and propagates the effects system-wide. For example, a shock of 1 percent dollar appreciation against a wide basket of other currencies was shown to reduce economic growth of a 21-emerging countries group by 0.3 percent. Given globalisation intensification, external shocks are likely to become more frequent and severe.

Conclusively, the book "Foreign Exchange Constraint and Developing Economies" explores the vulnerabilities of emerging economies and the remedial policy decisions that were required because of elevating globalisation. Policymakers and economists could find it enlightening to delve into the country/region-specific issues explored. Additionally, this text could assist in building strategies to improve sustainability efforts and harness the power of globalisation whilst using instruments and policies to mitigate a country's foreign exposure risk. Appreciably, challenges specific to climate change and a new wave of automation resultant from advancements in artificial intelligence are crucial to current and future industrial policies, revealing an area of potential research.

References

Abuselidze, G., & Slobodianyk, A. (2020). Pandeconomic Crisis and Its Impact on Small Open Economies: A Case Study of COVID-19. *International Scientific Conference Energy Management of Municipal Facilities and Sustainable Energy Technologies EMMFT 2019*, 718–728. https://doi.org/10.1007/978-3-030-57450-5_61

Blackman, Courtney. 1976. "Managing Reserves for Development." *Columbia Journal of World Business* 11 (3): 34–40. https://web.p.ebscohost.com/ehost/detail/detail?vid=18&sid=46900c8c-e077-495f-908f-d2df9ffb0ec7%40redis&bdata=JnNpdGU9ZWhvc3QtbGl2ZQ%3d%3d#db=bsu&AN=5546199.

Central Bank of Barbados Review of the Barbados Economy: January-September 2023. (n.d.). Central Bank of Barbados. https://www.centralbank.org.bb/news/economic-reviews/central-bank-of-barbados-review-of-the-barbados-economy-january-september-2023

Coeurdacier, N., Rey, H., & Winant, P. (2019). Financial Integration and Growth in a Risky World. *Journal of Monetary Economics*. https://doi.org/10.1016/j.jmoneco.2019.01.022

Eichengreen, B., Hausmann, R., & Panizza, U. (2003). *NBER Working Paper Series Currency Mismatches, Debt Intolerance and Original Sin: why they are not the same and why it matters*. https://www.nber.org/system/files/working_papers/w10036/w10036.pdf

GDP growth (annual %) - Latin America & Caribbean | Data. (n.d.). Data.worldbank.org. https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=ZJ

Maldonado, R., & Harris, J. (2022). Remittances to Latin America and the Caribbean in 2021: Migrant efforts during the COVID-19 crisis. *Publications.iadb.org*. https://doi.org/10.18235/0004343

Parker, R., & Cox, S. (2020). The State and the Extractive Industries in Australia: Growth for Whose Benefit? *The Extractive Industries and Society*, *7*(2), 621–627. https://doi.org/10.1016/j.exis.2020.02.001