

Effects of Exchange Rate Changes on Capital Flows

S. Sundararajan

The behaviour of the capital movements with respect to changes in exchange rate has not been studied so far in the Indian literature. The purpose of this paper is, therefore, to study the effects of changes in exchange rate on capital movements by using the Portfolio Equilibrium Model (PEM) and Macroeconomic Model (MEM) developed by Kouri and Porter (1974) and to examine the comparative performance of both these models in this respect. The paper attempts a detailed analysis of the capital flows in India's BoP vis-a-vis exchange rate changes during the period 1960-61 to 1984-85. The results indicate a very strong relationship between trade flows and short-term capital movements. Another interesting aspect of the results is that income is highly significant in explaining the capital flows in all the cases. In India PEM seems to be more helpful in estimating the short-term and long-term capital movements. The reduced form of MEM does not appear to be useful.

Introduction

The current regime of frequently fluctuating exchange rates serves as a useful context for renewed discussion of the precise effects of changes in exchange rate on the trade balance, the balance of payments (BoP), capital movements, etc. changes in exchange rates, particularly devaluations, have become the subject of lengthy discussions within the academic, business and government communities. The descriptions pertaining to the effects of devaluation in these discussions can be bifurcated into two basic categories. On the one side of the issue are those who feel that exchange rate changes provide positive income and employment effects and eventually improve the trade balance. On the other side are those who feel that change in exchange rate lead to an increase in the level of international reserves through an improved BoP. Historically the income and employment effects of increased trade balance have dominated the analysis. It was not until the last two decades, with the rediscovery of the Monetary Approach to the BoP, that the second category emerged as a separate and an independent method of analyzing the effects of devaluation.