

Exchange Rates and Managing Volatile Flows

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It is well-known that ensuring some stability and desired level of the exchange rate is critical for macroeconomic strategy for development, especially in low and middle income countries. Yet in a world of liberalised and volatile capital flows, this has become much more difficult for policy makers in such countries.

Increasingly, exchange rate movements are not determined by so-called “fundamentals”, but by flawed risk perceptions as well as domestic macroeconomic strategies. Both monetary policy and fiscal policy must react to the actual or potential movements of cross-border capital that largely determine the movement of nominal exchange rates. These movements then set off domestic economic processes, such as changes in inflation, as well as responses (such as changes in interest rates) that affect real economic activity in often adverse ways.

To see how this has played out in the recent past, let us examine the recent pattern in some of the more prominent middle income countries: India, Brazil and South Africa. These are among the largest economies in their respective regions, part of the IBSA grouping, and significant members of G20. They have had higher growth rates in the recent past than most advanced economies, and significantly, they are also not debt-stressed countries. External debt to GDP ratios in these countries is relatively low, especially when compared to some rich countries: 17 per cent for Brazil, 20 per cent for India and 47 per cent for South Africa in 2025, compared to 96 per cent for the US, 105 per cent for Japan, 150 per cent for Canada and Austria, and as much as 270 per cent for the UK. (<https://www.focus-economics.com/economic-indicator/external-debt/>).

However, all of them (unlike China) have largely liberalised their external accounts to deregulate cross-border flows of capital almost completely. This has led to significant loss of domestic policy space because of the fear of outflows of legacy capital and consequent internal destabilisation.

In addition, it has meant that even these relatively large and important economies are trapped in a vicious cycle of nominal devaluation-domestic inflation-further devaluation that does not generate higher exports or greater external “competitiveness”. Instead, it adversely affects the livelihoods and living standards of the bulk of the population.

Plummeting Rupee

Consider first India, for which the data are presented in Chart 1 and 2. In the past decade, and especially since 2017, the rupee has depreciated substantially in nominal terms, falling by nearly 20 per cent across the top 40 trading partners. But in real terms, the exchange rate has barely shifted, with only marginal changes over the entire period, such that the level in 2025 was only 2 per cent below that in 2016.

CHART 1

Rupee dip: Nominal vs Real

India: Nominal and real exchange rates and policy interest rate

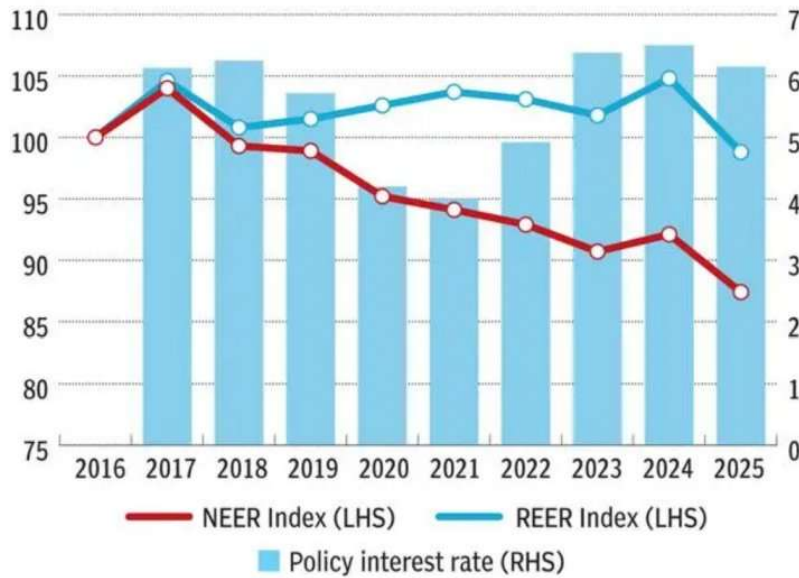
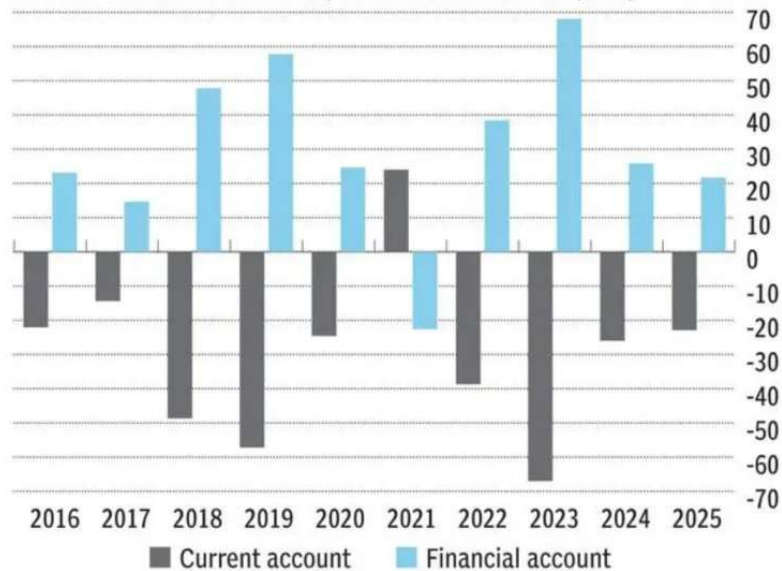


CHART 2

Impact on flows

India: Net external accounts, current and Financial (\$ bn)



The NEER refers to the nominal effective exchange rate, based on weighted trade with 40 top trading partners; the REER refers to the Real Effective Exchange Rate with the same nominal rate adjusted for relative rates of inflation across the 40 top trading partners. All data

are averages over the calendar year. The numbers provided for the exchange rates are index numbers with 2016=100 and calculated so that a decline reflects a depreciation.)

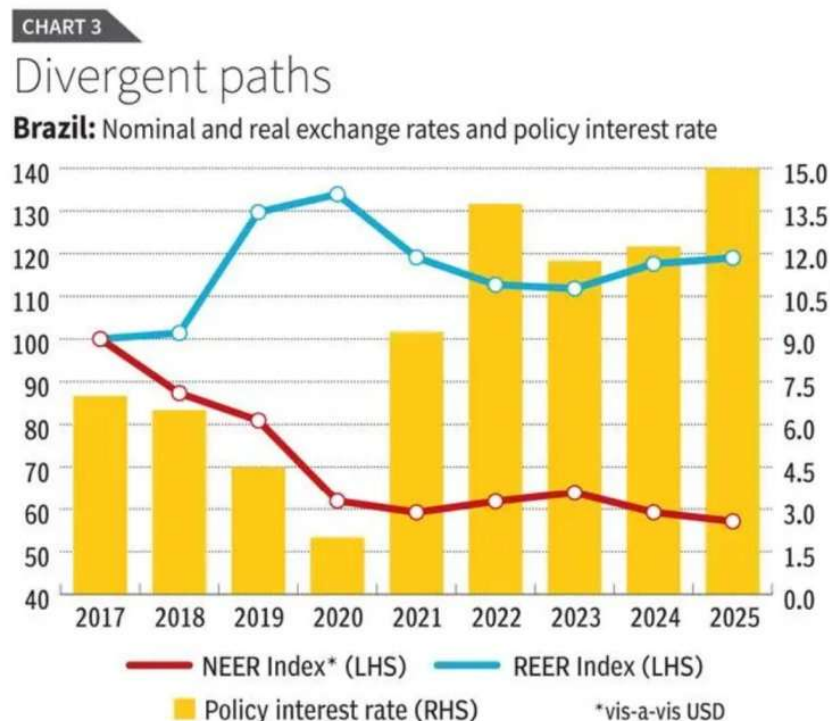
It is worth noting that the nominal exchange rate continued to decline despite significant increases in the domestic monetary policy interest rate from 2022 onwards, which were largely in response to the rise in US Fed rates after the onset of the Ukraine war and associated inflation resulting from higher global food and fuel prices.

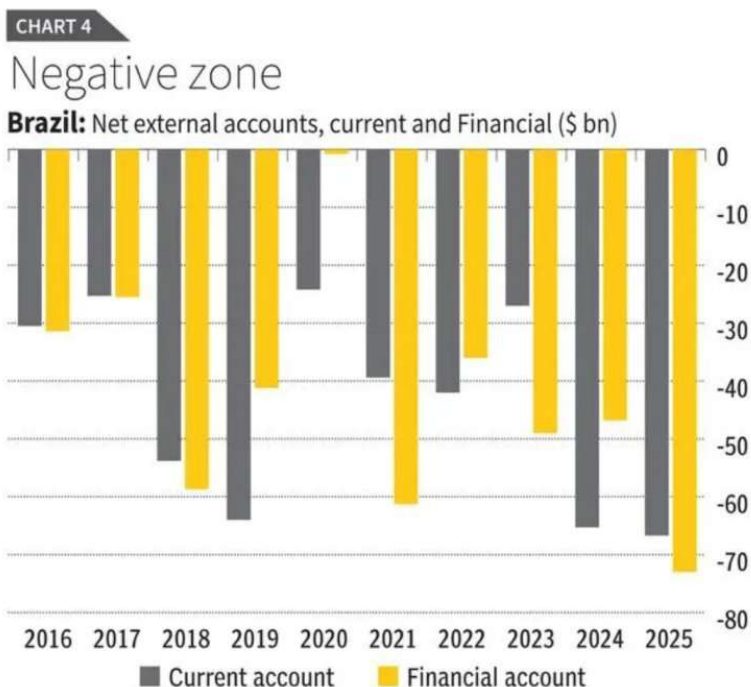
Did the depreciating nominal exchange rate have a positive impact on the current account? This would only be expected if the real exchange rate also moved accordingly, which we have observed did not occur.

But perhaps the increase in the policy interest rate had a favourable impact on net financial flows? Figure 1b suggests that there was an increase and a shift from negative flows to positive flows in 2022 and 2023, but the effect was relatively short-lived. In the subsequent two years, net capital inflows declined sharply to fall to nominal levels of a decade earlier, which suggests a substantial decline in real terms.

Brazil's Experience

A very similar trajectory is evident for Brazil, even though as an energy and commodity exporter it actually benefited from the global price hikes in food and fuel commodities. Chart 3 show that the real exchange rate even appreciated as the nominal exchange rate (here relative to the US dollar) declined by as much as 43 per cent over the entire period. This is because of faster inflation in Brazil than in the trading partners, but the problem is circular since rising import prices contribute to domestic inflation.





As in India, the domestic monetary policy interest rate was reduced during the Covid-19 pandemic. The decline was significant, to only 2 per cent, but it was dramatically increased in the following year to an average of 9.25 per cent in 2021. By 2022, it was as high as nearly 14 per cent, which means a much higher effective lending rate for businesses and personal loans. This did not do much to improve the situation in terms of capital flows. Both current and financial accounts of the balance of payments remained negative throughout this period, and the net financial outflows, which had worsened in 2021 (probably leading to the rise in the policy rate in 2022) were even greater in 2025.

South Africa's Trajectory

South Africa also shows a broadly similar trajectory, with some interesting differences. In the South African case, the real exchange rate did move in the same direction as the nominal exchange rate, albeit to a much more limited extent. The monetary policy response to the Covid-19 pandemic was also sharp, with a drop in the policy interest rate from 6.5 per cent in 2019 to 3.5 per cent in 2020. By 2020 the average policy rate had doubled to 7 per cent and it continued to increase in 2023.

CHART 5

Similar paths

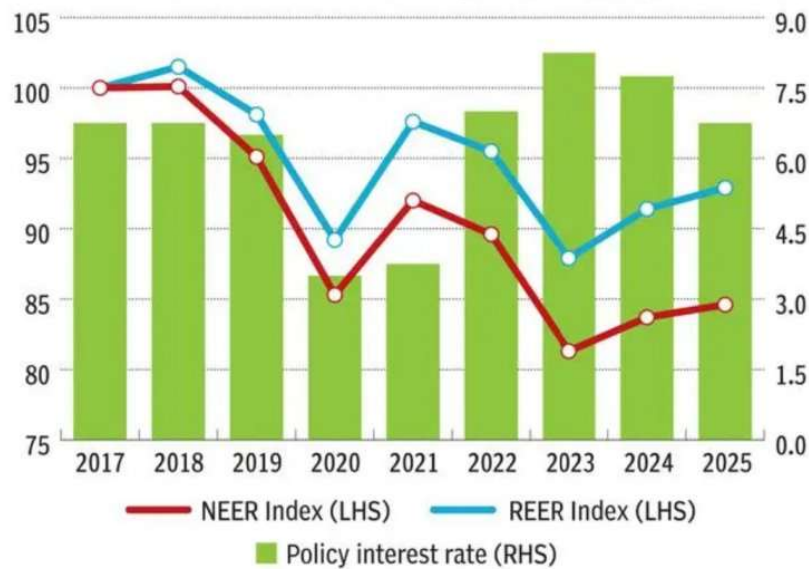
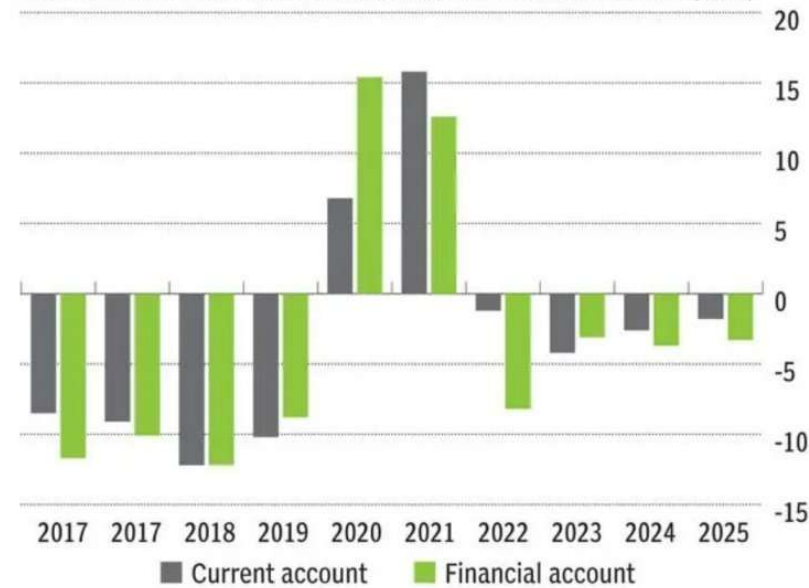
South Africa: Nominal and real exchange rates and policy interest rate

CHART 6

Swing in flows

South Africa: Net external accounts, current and Financial (\$ bn)

Source for all figures: CEIC database, using IMF databases on exchange rates and balance of payments

Surprisingly, both current and financial accounts in South Africa turned positive during the pandemic years of 2020 and 2021. But thereafter they turned negative again, despite the

significant nominal devaluation and the rising interest rate presumably designed to attract capital.

These broadly similar trajectories of exchange rates, interest rates and capital flows in very different economies suggest that there is a pattern that goes beyond the macroeconomic policies of these countries. This is the baneful influence of investor perceptions in a world of currency hierarchies, which determine capital flow movements that are largely beyond the powers of domestic policies to influence.

In such a world, neither fear (strict fiscal discipline) nor courage (attempting countercyclical policies) saves you. Ultimately, controls on volatile capital and moving away from reliance on external financing as far as possible may be essential preconditions for successful macroeconomic management.

As Keynes famously argued, “above all, let finance be primarily national”.

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