

How changes in exchange rates affect stock market performance in emerging countries

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Abstract:

This study investigates the complex and often contradictory relationship between exchange rate fluctuations and stock market returns, with a specific focus on emerging economies. Utilizing a qualitative methodology based on an extensive review of existing academic literature and econometric studies, the research evaluates two primary theoretical frameworks: the flow-oriented model, which posits that currency movements drive firm competitiveness and stock prices, and the portfolio balance approach, which suggests that equity market trends dictate currency demand through capital flows.

The findings indicate that the correlation between these two variables is dynamic and highly dependent on a country's economic structure, trade openness, and investment horizon. While currency depreciation can enhance the profitability of export-oriented firms, it simultaneously poses significant risks for import-dependent sectors and can deter foreign direct investment. Furthermore, the study highlights the emergence of a bidirectional relationship in markets with high capital mobility. The paper concludes that for investors and policymakers in emerging markets, managing currency risk is as vital as managing asset-specific risk, necessitating the use of sophisticated hedging strategies and stable monetary policies to ensure long-term financial stability.

Keywords:

Exchange Rate Volatility, Stock Market Returns, Emerging Economies, Currency Risk, Flow-Oriented Model, Portfolio Balance Approach, Bidirectional Relationship, Capital Flows, International Finance.

Introduction: "The What & Why"

Nowadays, due to the always increasing globalization money moves flawlessly across the world. The absence of borders and clear separation links currency markets and stock markets more closely as time passes. Exchange rates, which used to mainly affect trade, now are a determining factor in international investments, asset values, and financial stability. This is especially true in emerging economies, where markets are more sensitive to external shocks, currency fluctuations, and changes in capital flows.

Usually, markets in emerging countries tend to see higher exchange rate volatility or fluctuation than developed countries due to political instability, and dependence on foreign investment. The change in exchange rates impact the value and amount of foreign investments as well the performance of companies involved in international trade. Export competitiveness, production costs, and investor's trust are all affected by currency fluctuation, and the change in any of those factors affects in turn stock market returns

Without a doubt exchange rate movements is a considerable risk that differs from already known market risks. But not all risks are synonym of decrease in portfolio returns; and this is where it is important to find and identify the correlation between these risks and the stock market return. Therefore, understanding how exchange rates and stock markets interact is vital for managing investments, assessing risks, and maintaining financial stability.

While some studies may show a that a weaker currency boosts firm competitiveness & support stock, others find that it discourages foreign investment harming stock markets.

Some studies suggest that a weaker currency can boost competitiveness and support stock prices. The purpose of this study is to review existing research and contradicting findings on the relationship between exchange rate changes and stock market performance especially in emerging economies. By analyzing previous findings on volatility, correlation, and interactions, the goal would be to offer a clearer definition of the linkage between stock market returns and exchange rate changes.

Literature Review: "The story so far "

In international finance exchange rate changes and stock market performance is a complex connection that has yet to find a definitive answer.

On one hand the flow-oriented model highlights how currency movements impact firms' international success. On the other, the portfolio balance approach indicates that stock market trends can influence exchange rates through cross-border capital flows. Understanding this relationship helps investors and policymakers manage risks in international financial markets effectively.

When investors hold foreign equities, their returns do not only depend on stock price performance but also on currency fluctuations, since returns must be converted into the investor's domestic currency. This would mean that currency appreciation should increase foreign investment returns, while depreciation should reduce them.

(Morningstar, 2023; Charles Schwab, 2023).

Research also suggests that exchange rate fluctuations influence stock prices through trade competitiveness effects. When a domestic currency depreciates, exports become cheaper in international markets, which increases revenues and profitability for firms based on exportation,

which would potentially lead to higher stock prices for these firms. On the other hand, a strong currency would reduce export volume & competitiveness and negatively affect company performance. These effects are even more important in emerging economies where firms rely heavily on international trade and foreign capital (IG Group, 2018).

In addition, the role of currency risk in shaping a portfolio's returns is discussed.

Investors exposed to foreign markets must consider both asset risk and currency risk, as exchange rate movements can either amplify or reduce total returns.

Certain studies show that the increase in volatility in portfolios, particularly in the short term focused portfolios comes from currency risk, but its impact in the long term would be almost insignificant as currency movements tend to offset each other over time. This highlights the importance of investment horizon (whether it is viewed as a long- or short-term investment) when evaluating the relationship between exchange rates and stock market returns

(IG Group, 2018; Morningstar, 2023; Charles Schwab, 2023).

Empirical research reinforces that theory that the relationship between exchange rates and stock prices is not constant but varies across countries and time periods. The correlation between the two variables changes depending on macroeconomic conditions, financial crises, and investor expectations. Some studies find that, on average, exchange rate changes won't significantly affect long-term stock returns across a large number of countries, suggesting that the relationship depends more on each country's factors and market structure

(World Economic Forum, 2015; Nieh & Lee, 2001).

Furthermore, it was deduced that both markets influence each other. Changes in stock prices may attract foreign investment, increasing demand for domestic currency and leading to currency appreciation. When at the same time, exchange rate movements affect company earnings, which in turn influence stock prices. This 'bidirectional relationship' explains why many studies use econometric models such as cointegration and Vector Autoregression (VAR) to capture both short-run and long-run equilibrium relationships (IG Group, 2018).

Overall, previous research confirms that exchange rates and stock markets are not entirely related, but can affect each other. the strength and direction of this relationship vary depending on economic structure, market conditions, and investment horizon. While some studies find significant relationships between exchange rate movements and stock returns, others find weak or time varying correlations. This divergence in findings highlights the importance of further research focusing on emerging markets, where financial systems are more exposed to currency volatility and external shocks.

Methodology: "The how we did it "

This research adopts a qualitative approach based on an extensive review of already existing academic literature related to exchange rate movements and stock market performance in worldwide economies (specially emerging economies). This Study did not select any primary numerical data, but relied on previously published research in order to identify common findings, theoretical explanations, and gaps or differences in the literature.

Numerous academic papers were found using research tools such as Consensus, Google Scholar, and University's libraries databases. The search process included keywords like "exchange rate volatility & stock market returns", "emerging markets", "currency risk", "cointegration & VAR

models". Studies were chosen based on the number & quality of reviews from journals and peers, also widely cited studies were given priority in order to ensure the reliability and credibility of the information.

After selecting the most relevant studies, the findings of each paper were reviewed and compared. Attention was given to the research methods used by previous authors, the variables analyzed as well as the conclusions reached regarding the relationship between exchange rate movements and stock market performance. The literature was then organized according to major themes, including the impact of currency depreciation on equity markets, volatility transmission effects, and long-run relationships between macroeconomic variables.

The objective of this approach is to combine existing findings in order to provide a clear understanding of how exchange rates influence stock market returns in emerging economies (specially). By comparing different empirical results and theoretical perspectives or approaches, the study identified areas of agreement and disagreement among researchers and highlighted the reasons of certain gaps in findings.

This methodology ensures transparency and neutrality, and it also enable replicability as other researchers can follow the same literature selection process using similar or different keywords and academic databases depending on the outcome that they want.

Results: "The facts "

According to the reviewed research, there is a clear relationship between fluctuations in exchange rates and performance in the stock market, particularly in developing nations. Exchange rates and stock returns have been found to be volatile over time, primarily because of economic uncertainties and shocks from around the world. When the economic situation turns uncertain or there is political turmoil, exchange rates are bound to become volatile, which might affect investments in the stock market. Exchange rate volatility has a significant impact on investments, particularly because currencies are used in the valuation of foreign investments, as well as the international competitiveness of businesses.

From the available studies, it is evident that the relationship between exchange rate and stock returns is dynamic in nature. In some countries and at particular points in time, depreciation may lead to increased exports and higher profits, therefore increasing stock prices. In other situations, however, depreciation can lower foreign investments, which may result in negative stock returns. There are instances when the two variables exhibit little to no relationship at all.

A relationship working both ways may also exist, where changes in the exchange rate affect the prices of stocks, while changes in the stock market impact the exchange rate due to capital flow from other nations. From the findings, it emerges that exchange rate fluctuations, international exposure, and capital mobility have an effect on the outcome of the stock market. This is especially true for the emerging markets that are vulnerable to external influences.

Discussion and conclusion: "The so what ? "

In general, it is assumed that when there are fluctuations in exchange rate movements, the stock exchanges in developing economies respond accordingly. It is essential for investors to be aware of the currency risk when making decisions concerning investments internationally. Exchange rate movements may have an effect on stocks indirectly through a number of channels such as influence of exchange rate on international competitiveness and profitability of the firms as well as

international financing. However, the effect is not the same in all cases and it depends on certain characteristics of the economy like the composition of the economy, openness and degree of development of the financial markets. The relationship of exchange rates and stock prices indicates that there must be consideration of economic factors while investing.

A stable currency exchange rate plays an important role in promoting sustainable growth in the financial sector by enhancing trust and reducing uncertainty. In addition, positive economic conditions encourage investments from abroad, ensuring sustainable growth.

Future studies can be focused on the impact of other economic indicators, such as interest rates, inflation, trade balance, and others on the behavior of the stock market. Comparative analysis of the relationships between exchange rates and stock markets of developing countries and developed nations may help determine how this relationship varies according to the economic development level of the nation in question.

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