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# The terms of trade, productivity growth and the current account<sup>☆</sup>

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## Abstract

This paper extends the analytical framework provided by Glick and Rogoff (1995, *Journal of Monetary Economics* 35, 159–192) to an economy with traded and nontraded goods, and it analyzes the impact of country-specific and global productivity shocks on the current account and investment. Each of these disturbances have different implications for the current account and investment that are largely consistent with the empirical results. First, the current account responds more than investment to country-specific traded productivity growth. Second, global traded productivity and country-specific nontraded productivity growth have no effect on the current account, but they have a significant impact on investment. Third, the global component of nontraded productivity is negligible and has no significant impact on either the current account or investment. In addition, the response of the current account and investment to relative prices (the terms of trade and exchange rate) are insignificant. This paper also discusses the potential reasons for it. © 2000 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

One of the most important contributions of the intertemporal approach to macroeconomics has been in the study of international capital flows and the current account behavior. Sachs (1981), for instance, applied this framework to the less developed countries' current account deficits in the 1970s, and interpreted these deficits as responses to favorable terms of trade movements. Sachs' study represents an earlier attempt to explain data using a relatively simple (two-period) intertemporal model and reduced form cross-country regression equations.

Since then a large theoretical literature has extended the basic intertemporal approach to the current account and has introduced a much richer dynamics into the model. One strand in the literature has studied the international transmission of aggregate output fluctuations using stochastic dynamic general equilibrium models in which aggregate productivity shocks are the main source of fluctuations. Based on this framework, some researchers have employed numerical solution techniques in which predetermined model parameters are used to generate simulated variances of and correlations between endogenous model variables (cf. Backus et al., 1994; Stockman and Tesar, 1995).

Recently, Glick and Rogoff (1995) have introduced an innovative approach to study macroeconomic relationships in an open economy. Their approach involved deriving analytically tractable current account and investment equations when there are global and country-specific productivity shocks. In a nutshell their model makes two predictions. First, country-specific productivity shocks affect the current account more than investment, because both consumption and investment respond to changes in productivity inducing a larger response by the current account. Second, global productivity shocks have no impact on the current account because, in the face of a global shock, countries with similar endowments and technologies adjust their consumption and investment symmetrically. Glick and Rogoff also econometrically estimate the model using data from the G-7 countries and find evidence which supports these predictions.

This paper extends the analytical framework laid out by Glick and Rogoff (1995) to an economy with traded and nontraded goods. As I discuss in Section 2, the existence of traded and nontraded goods introduces additional features into the analysis. In this case, country-specific productivity growth affects the current account more than investment only when the change in productivity originates from the tradable goods sector. When the country-specific productivity growth originates from the nontradables, the model predicts that the current account and investment would respond by about the same in absolute value. Since, by definition, domestic consumption of nontradables equals domestic output, there should be no consumption smoothing of nontradables across borders. Thus, the main impact of nontradable productivity growth on the current account results from changes in investment. On the other hand, when

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