Wearing corset, losing shape: The euro’s effect on trade imbalances

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Abstract

When does trade become a one-way relationship? We study bilateral trade balances for a sample of 18 European countries over the period from 1948 through 2008. We find that, with the introduction of the euro, trade imbalances among euro area members widened considerably, even after allowing for permanent asymmetries in trade competitiveness within pairs of countries or in the overall trade competitiveness of individual countries. This is consistent with indications that pair-wise trade tends to be more balanced when nominal exchange rates are flexible. Intra-euro area imbalances also seem to have become more persistent with the introduction of the euro, some of which is linked to labor market inflexibility. Reviewing the direction of imbalances, we find that bilateral trade surpluses are decreasing in the real exchange rate, decreasing in growth differentials, and increasing in the relative volatility of national business cycles. Finally, countries with relatively higher fiscal deficits and less flexible labor and product markets exhibit systematically lower trade surpluses than others.

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1. Introduction

Imbalances in bilateral trade relationships have recently raised considerable interest. For many countries, the difference between the value of shipments to and from a particular partner has risen sizably in recent years. More notably, large bilateral imbalances appear to increasingly dominate some countries’ overall trade balance. A prominent example is the trade deficit between the United States and China, which increased from virtually zero in the mid-1980s to more than 225 billion US dollars in 2009, accounting for almost one half of the US total trade deficit. For Italy, the trade deficit with Germany has risen by a factor of 5 within a decade, now even exceeding the country’s overall deficit in external trade.

While there is no economic reason to assume that a bilateral trade relationship should necessarily be balanced, the emergence of large and persistent trade imbalances is often interpreted as prima facie evidence of underlying rigidities or distortions. For example, protectionist measures can bias trade in favor of a particular country. Similarly, distortionary policies could delay a country’s external adjustment to shocks. Also, fixed or managed exchange rates may slow corrections of the real exchange rate.

The lack of an adjustable nominal exchange rate supposedly poses a particular problem within a currency union that also operates a single and unrestricted market for goods and services, such as the euro area. In this case, the permanently fixed nominal exchange rate forces real exchange rate adjustment through relative price levels alone, which can be difficult in the presence of rigidities in national goods and labor markets. Surprisingly, however, the empirical evidence on the link between trade imbalances on the one hand and exchange rate flexibility and structural rigidities on the other appears to be generally mixed.

In this paper, we identify several new stylized facts on intra-European trade that can add to this discussion. Specifically, we examine the patterns of trade between a sample of 18 European countries, some of which have adopted the euro as their common currency, over the period from 1948 through 2008. Previewing our main results, we find that trade imbalances—measured as the fraction of deficits and surpluses in total bilateral trade—have indeed widened considerably between euro area member countries after the introduction of the euro. Moreover, since we control for various sets of country-specific and pair-wise fixed effects, our analysis indicates that the larger imbalances are not (only) the result of enduring asymmetries in trade competitiveness between a given pair of countries or the consequence of changes in the institutional framework, financing conditions, or trends in the competitiveness of specific countries against all others. Finally, we establish that intra-euro area imbalances have become more persistent, which can be partially linked to labor market inflexibility.

Reviewing the direction of pair-wise trade imbalances, we find that bilateral trade surpluses are decreasing in the real exchange rate, decreasing in growth differentials, and increasing in the relative volatility of national business cycles. Also, countries with relatively higher fiscal deficits and less flexible labor and product markets exhibit systematically lower trade surpluses than others. Finally, it seems reassuring to note that many of these effects are particularly developed among euro area member countries. In summary, these findings entail, in our view, both bad and good news for policymakers in the euro area. On the negative side, permanently fixed nominal exchange rates do come at the cost of large and lasting trade imbalances. On the plus side, these imbalances can be addressed through structural and macroeconomic policies.

The remainder of the paper is organized as follows. In Section 2, we briefly review the relevant literature. Section 3 describes the empirical methodology and the data. We begin our
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