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External wealth, the trade balance, and the real exchange rate

Philip R. Lane[a,c,*], Gian Maria Milesi-Ferretti[b,c]

[a] *Institute for International Integration Studies, Trinity College Dublin, Dublin, Ireland*
[b] *International Monetary Fund, Washington, DC, USA*
[c] *CEPR, London, UK*

Abstract

We examine the link between the net foreign asset position, the trade balance and the real exchange rate. In particular, we decompose the impact of a country's net foreign asset position ('external wealth') on its long-run real exchange rate into two mechanisms: the relation between external wealth and the trade balance; and, holding fixed other determinants, a negative relation between the trade balance and the real exchange rate. We also provide additional evidence that the relative price of nontradables is an important channel linking the trade balance and the real exchange rate. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

The rapid growth in the net external liabilities of the US and its implications for a possible reversal in the current strength of the dollar are a dominant theme of discussion in economic policy circles. This theme is certainly not new: the debate on the relation between international payments and real exchange rates has a long and distinguished intellectual history, and was at the forefront in the late 1920s, with the debate between Keynes and Ohlin on the impact of German war reparations, in the 1970s, with the debate on the implications of oil price shocks, in the early 1980s in the aftermath of the debt crisis, and in the mid- and late 1980s, with the debate on causes and consequences of the large swings in the value of the dollar. [1]

* Corresponding author.
E-mail addresses: plane@tcd.ie (P.R. Lane), gmilesiferretti@imf.org (G.M. Milesi-Ferretti).

[1] See also Krugman (1987, 1991), Obstfeld and Rogoff (2001a).

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In this paper, we revisit the relation between international transactions, net external asset positions, and the real exchange rate, making use of a new data set on external assets and liabilities that we recently constructed (Lane and Milesi-Ferretti, 2001a). Our approach is empirical, and focuses on long-run relations between these variables. In simple terms, the standard argument linking net foreign assets, the trade balance and the real exchange rate runs as follows. A positive steady-state net external asset position enables a country to run persistent trade deficits. In turn, all else equal, the capability to sustain a negative net export balance in equilibrium is associated with an appreciated real exchange rate. Conversely, a debtor country that must run trade surpluses to service its external liabilities may require a more depreciated real exchange rate.

In previous empirical work, Faruqee (1995), Gagnon (1996), Broner et al. (1997), Alberola et al. (1997), Lane and Milesi-Ferretti (2000) have provided estimates of a positive long-run relation between net foreign assets and the real exchange rate, using a variety of data, methods and specifications.[2] In this paper, we instead decompose this relation into two parts: (i) the relation between the net foreign asset position and the trade balance; and (ii) the relation between the trade balance and the real exchange rate. We argue that explicitly allowing for this decomposition is important both theoretically and empirically, and provide econometric evidence to back this argument.

Indeed, the size of the trade surplus that a debtor country has to run to service its external liabilities will depend on the rate of return it has to pay on these liabilities, as well as on its output growth rate. For instance, going back to the US example, a debtor country that grows quickly and manages to earn returns on its foreign assets that are higher than the payouts on its foreign liabilities requires a much smaller trade surplus to stabilize its net foreign asset position than a country with poor growth performance and unfavorable net investment income flows. By extension, the magnitude of any real exchange rate depreciation will be smaller in the former case. In the empirical analysis, we provide direct evidence on how the relation between the trade balance and net foreign assets depends on investment returns, output growth and exchange rate movements.

We also highlight that the link between trade balance and real exchange rate depends on other factors, such as relative output per capita, relative productivity levels, and the terms of trade, and we provide evidence on the economic and statistical significance of long-run co-movements between these variables. The empirical analysis focuses on a sample of OECD economies for the period 1970–1998. By selecting this group of countries for which higher-quality data are available, we are able to refine our empirical analysis – for instance, by directly controlling for productivity variables in estimating the long-run relation between the trade balance and the relative price of nontradables. In addition to the trade balance, our empirical findings confirm the importance of relative productivity as a key determinant of the relative price of nontraded goods and the real exchange rate.

[2] Lane and Milesi-Ferretti (2000) emphasize the relative price of nontradables as the primary endogenous component of the real exchange rate. In contrast, the other papers rule out any effect of external payments on the relative price of nontradables by including proxies for that relative price as regression controls.

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