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Does the J-Curve Hypothesis Hold for a Small Open Economy? Evidence from Time-varying Coefficients of a Distributed-lag Model for Tunisia
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Abstract
This paper determines how the Tunisian trade balance reacts to exchange rate changes during the post liberalization period, 1993:01 to 2014:03. To achieve this, a state space specification technique is employed to estimate a trade balance model for Tunisia. Our findings suggest that the real effective exchange rate has a significant impact on the trade balance of Tunisia, showing oscillating effects that can be best described by a “W-curve.”

Keywords: Trade balance, Effective real exchange rate, J-curve, Kalman Filter
Jel Classification: F14, F31, F32, C32

1. Introduction

Growing trade deficit has been one of the major problems of Tunisia despite the government’s strong willingness to enforce exports and facilitate trade. During the last two decades, Tunisia’s merchandise trade deficit averaged about 13% of GDP and reached as high as 17% of GDP in recent years. In particular, merchandise exports of Tunisia represented on average about 33 % of GDP, and merchandise trade accounted for an average of 78% of GDP. In fact, Tunisia is a small open economy whose growth is highly dependent on export revenues. Consequently, like many developing economies, Tunisia relies much on exchange rate policies that help improving trade balance and enhance competitiveness in the international market. Thus, determining the relationship between the trade balance and the real exchange rate for such a small open economy can undoubtedly provide policymakers with an excellent tool to evaluate and assess the effect of central bank intervention.

It is widely believed that the impact of the exchange rate changes on the trade balance follows a J-curve. According to this phenomenon, depreciation or devaluation worsens the trade balance in the short-run and improves it in the long-run, Magee (1973). However, for the depreciation or devaluation to be balance improving, the Marshall-Lerner condition should be satisfied. That is, sum of absolute values of export and import price elasticities must be greater than unity.

A large number of studies have attempted to test this phenomenon using different techniques and different model specifications. Bahmani-Oskooee and Ratha (2004a) and Bahmani-Oskooee and Hegerty (2010) went over the literature, examined and reviewed several methodologies used to test whether currency depreciation worsens the trade balance first before improving it. The main finding is that the short-run response of the trade balance to currency devaluation does not follow any specific pattern and the results are country specific. Numerous recent studies have been using cointegration analysis to verify the J-curve
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