The terms of trade, the external balance, and the size of the net foreign asset position

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Abstract

In this paper, we study the extent to which the enormous increase of cross-border holdings of capital impacts the manner in which the terms of trade affect a country’s external balance. We find that the impact of a shock in the terms of trade on the external balance depends on whether the traditional rule or the new view for the current account dominates. If the new view for the current account holds, the Harberger-Laursen-Metzler effect holds for creditor countries: a deterioration of the terms of trade deteriorates the external balance. However, if the traditional rule dominates, changes in the terms of trade may not affect the external balance, and the effect fails to hold. The empirical evidence, based on a sample of 37 countries from 1970 to 2009, shows that when the ratio of the net foreign asset position is approximately between and as a share of domestic wealth, the new view dominates and the effect holds for creditor countries; however, in large creditor or debtor countries, the traditional rule dominates, and the effect ceases to hold.

\textit{JEL classification:} F41; F43

\textit{Keywords:} Trade balance, current account balance, external balance, terms of trade, net foreign asset position, new view, traditional rule.

1. Introduction

Changes in the terms of trade are widely recognized for creating important changes in income, savings and the external balance. The conventional wisdom regarding the impact
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