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Exchange Rate and Foreign Trade: A Comparative Study of Major South Asian and South-East Asian Countries

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Abstract

The main purpose of this study is to examine the relationship of exchange rate with exports and imports of major South-Asian and Southeast Asian Economies. The Autoregressive Distributed Lag (ARDL) approach to co-integration and error correction model is employed to investigate the long run and short run relationship between the variables in sample economies over the period of 1979-2010. The results show that the long run relationship between exchange rate and exports exists in more than half of the sample countries; however, the relationship between exchange rate and imports is found only in one sample country. Moreover, the significant short run relationship between the variables is not found in majority of the sample countries.

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1. Introduction

The foreign trade is considered as an important determinant in the economic growth of a country. It is recorded in current account of Balance of Payments (BOPs). The exports are recorded on credit side of BOPs whereas the imports are recorded on debit side of BOPs. According to Dewett (2005), the factor endowments having productive power are unevenly distributed among different countries of the world and therefore, international trade is inevitable because of marked differences regarding materials, natural vegetation, climate, soil and other physical as well as geographical conditions. He further added that the stage of economic development, accumulation of capital & its foreign investment, technological progress, regulations and political affiliations may also result in international trade. There are different theories about international trade including mercantilism in 17th & 18th century, absolute

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advantage theory, and comparative/relative advantage theory, theory of general equilibrium and theory of opportunity cost. The most important is the theory of comparative advantage presented by Ricardo (1817), in which he argued that a country can specialize in the production of those articles in which she has relatively more advantage or relatively least disadvantage in production and then export to other countries. It is not possible for any nation to produce each and every item by itself and then absorb by itself.The foreign exchange rate between two currencies is referred as the rate at which one currency is exchanged for other. The existence of different exchange rate systems in the world economy is evident from the existing literature. Initially, the economies were under Gold Standard that was prevailed since 1879-1934, with the exception of World War I. This system was representing the fixed exchange rate system. Then, Bretton woods system, under which US$ was tied to a certain quantity of gold and currencies of other countries were tied with US$, prevailed till 1971. This system was collapsed in 1971 and flexible exchange rate was introduced under which the exchange rate is being determined through the demand and supply of foreign currency in foreign exchange market. The managed float rate system is also prevailing and under this system the Government through central bank intervenes to keep the price/value of currency within certain limits. After the collapse of Bretton woods system, the exchange rate determination got importance and the behavior as well as the effects of exchange rate and its volatility have been discussed and are under-discussion as well.The behavior of exchange rate has been explained through different theories. However, the relationship between exchange rate and foreign trade can be explained better by using the absorption approach, originally presented by Alexander (1952) and upgraded later on. According to it, the excess production by a country than its absorption results in trade surplus and appreciation of its currency. Similarly, according to BOP theory, a deficit in current account leads to the depreciation of domestic currency whereas a surplus on current account results in appreciation of domestic country in comparison to the foreign currency. Considering its importance, many countries, under the framework of International Monetary Fund (IMF), devalued their currency to boost exports and discourage imports in order to correct disequilibrium in their BOPs.

This research is an attempt to explore the association between exchange rate and foreign trade of selected South- and Southeast Asian economies, during the period of 1979-2010. The Asia is the largest and most populous continent of the world and after Europe it has the largest share of GDP in all continents. The Asian economies are growing rapidly and this continent in also rich in natural resources. The Asia is mainly classified into six sub-regions and in this study the eight largest economies are selected as sample form two main sub-regions namely South Asia and Southeast Asia. The Pakistan, India, Bangladesh and Sri-Lanka are selected for study from the South-Asian Region whereas from the Southeast Asian region; Malaysia, Indonesia, Singapore and Thailand are selected. The sample economies are following the flexible/ managed exchange rate system since late 70's or early 80's. By employing the bound testing approach developed under autoregressive distributed lag framework for cointegration and error correction model; an attempt has been made to explore the relationship of exchange rate with exports as well as imports. Both long run and short run reactions of exports and imports separately to exchange rate are investigated. The results of bound testing approach under ARDL for both cointegration and ECM show the evidence of long run relationship between exchange rate and exports in Pakistan, India, Bangladesh, Sri Lanka and Indonesia whereas the relationship between exchange rate and imports is observed in case of Sri Lanka only. The results further reveal that a statistically significant short run relationship between exchange rate and exports is present only in case of Sri Lanka and Bangladesh; however, in majority of the countries this relationship is not detected.

2. Literature Review

The study of exchange rate and its relationship with different variables gained considerable importance in last few decades. It becomes a critical issue for professionals as well as researchers, especially in developing countries, since 1972; because many developing countries brought a shift in their exchange rate policy from fixed to floating exchange rate system. Different studies have been conducted to explore the relationship of exchange rate to trade with mixed results. The study in this area is yet inconclusive; however, there is a general consensus among professionals that for long run the trade balance is influenced by the exchange rate. Baharumshah (2001) documented the existence of stable as well as positive association of exchange rate to trade balance in long run in case of Malaysia and Thailand having bilateral trade with United States and Japan. Lal and Lowinger (2002) found

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