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Do capital importing countries pay higher prices for their imports of goods?

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ABSTRACT

We examine the effects that a country's net capital flows have on the (border) prices that a country pays for its imports of goods. Using data from 2000 to 2009 for 11 euro area countries we utilize a pricing-to-market specification to study exporters' pricing behavior to the rest of the countries in the sample, at the industry level, for 900 goods disseminated at the 4-digit Standard International Trade Classification level. This allows us to construct a panel dataset which contains observations across exporters, importers, industries and time. We find a strong positive influence of the importing country's net capital inflows on the border prices of its imports of goods. This result is robust across different specifications of the underlying model, as well as to different sample dis-aggregations across types of capital flows, product categories, and exporters.

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I am unable to carry the goat, put the ox then upon me.

Ancient Greek proverb

1. Introduction

The debate about the effects of financial globalization has attracted increasing attention since the onset of the recent – and still lingering – global economic and financial crisis (GEFC). But even before

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the crisis erupted, a considerable body of evidence was accumulating against the presumed beneficial effects of capital inflows (e.g. Prasad et al., 2007; Rodrik and Subramanian, 2009). A central tenet of the case against financial globalization has been that capital inflows aggravate the structural problems of distortion-ridden economies (e.g. by leading to real exchange rate appreciation).

The present paper presents evidence that there exists another (hidden) cost of capital inflows: capital importing countries pay – ceteris paribus – higher prices for their imports of goods. In effect, capital inflows allow domestic agents (households and firms) to operate, for as long as capital inflows last, with *softer*[1] budget constraints; cognizant of this, profit-maximizing foreign exporters respond by charging higher prices to agents based in countries flush with capital inflows.

The rest of the paper is organized as follows. In Section 2 we discuss some relevant theoretical considerations, survey the literature, and explain why our empirical investigation is guided by the well-developed econometric specifications of the *pricing-to-market* literature which developed out of concerns relating to exporter pricing behavior when the exchange rate changes.[2] Of course, the presence of pricing-to-market concerns does not depend on the existence of nominal exchange rate changes. As an illustration, consider Fig. 1 which displays the aggregate border (not consumer) price indices for the imports and exports of goods of two euro area countries, Germany and Greece. We choose these two countries as representative of the capital exporting group (Germany) and of the capital importing group (Greece). What Fig. 1 reveals is that the evolution of import prices in each country is strongly connected with its export prices, but not with each other.[3] We regard this as behavior consistent with the pricing-to-market hypothesis, since the importing country's export prices are a good proxy for domestic price/cost developments to which foreign exporters respond when setting their prices.[4]

In Section 3 we undertake a detailed econometric analysis of the issue by examining the export pricing behavior of 11 euro area countries.[5] Using annual data from 2000 to 2009, we try to explain exporters' pricing behavior to the rest of the countries in the sample, at the industry level, for 900 goods disseminated at the 4-digit Standard International Trade Classification (SITC- revision 3) level. Thus our econometric analysis builds on a panel dataset which contains observations across exporters, importers, industries and time, ending up with a total of *594,327* observations. This allows us to explore the fact that each exporting country's producers sell each good to different national markets,[6] but also to be able to derive the aggregate effect of a country's capital inflows on the prices it pays for its imports. We find that import prices are positively related to the level of net capital inflows of the importing country. This result is robust across different specifications of the underlying model, which involve the addition of a host of control variables like the importing country's per-capita GDP, consumption taxes, interest rate, and price developments, as well as each exporter's (average) price developments across all destinations.

Section 4 presents a series of robustness checks. We first split net capital inflows into their debt and non-debt (FDI) components and find that both components are significant determinants of exporters'

[1] The term is borrowed from Kornai (1980), who discusses in detail how soft budgets constraints can come into existence, and how they can affect agents' behavior.

[2] Krugman (1986) coined the term "pricing-to-market" to describe the phenomenon of exchange rate induced price discrimination in international markets.

[3] We note that, as far, as aggregate data are concerned, this is not a feature pertaining only to Germany and Greece, but holds for the other euro area countries as well. It is also worth noting that during the period examined there was a small improvement in the terms of trade for Germany and a small deterioration for Greece.

[4] The high correlation between import and export prices for each country could possibly be explained on the basis of intra-industry trade. This may indeed be a plausible explanation for Germany and France whose (international) trade pattern is mainly intra-industry; it is a less plausible explanation for Greece and Portugal whose international trade is more of the inter-industry type (see, e.g. Adam and Moutos, 2008). Moreover, if indeed intra-industry trade were responsible for the high correlation between import and export prices in each country, we would expect high correlation between the import price indices across countries.

[5] Euro-11 consists of Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain. These 11 countries plus Luxembourg were the initial members of the euro area when the euro was physically introduced.

[6] Kreinin (1977), Knetter (1989), and Marston (1990) are early papers which exploited the idea that each exporter sells in many countries in order to empirically gauge the effect of exchange rates changes on the pricing of exports to different destinations. Other investigations (e.g. Feenstra, 1989) focused on differences in the prices charged by exporters to foreign markets versus the prices charged in their home country.

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