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Exchange rates and trade balances under the dollar standard

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Abstract

This paper considers the impacts of discrete exchange rate changes in open economies with net foreign exchange liabilities and assets under the dollar standard. The author finds that the combination of wealth, price, investment, and indirect investment effects (when present) increases the complexity of predicting current account movements following exchange rate changes, which in many cases lead to ambiguous results. Because exchange rate changes can no longer be separated from domestic price-level and absorption effects, except in special cases, they cannot be used predictably, to adjust the trade balance.
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1. Introduction

Some commentators in western financial press have suggested that East Asian economies, especially China, have undervalued currencies and should seek to appreciate them (Goldstein, 2004; Lardy, 2003, 2005; Roubini, 2005). To reduce the trade surpluses, especially in bilateral trade with the US, these economies are advised to appreciate or freely float their currencies in the near future (Lardy, 2005). Instead of addressing the external imbalances by increasing national savings (public and private), the US government willingly and conveniently adopted this simplistic view, and has exerted pressures on China and other East Asian trading partners to adjust their exchange rate policies. This paper shows that the US trade deficit would not necessarily be alleviated by forcing creditor countries to appreciate.

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Most economists who propose to use exchange rate changes to adjust trade balances, have the elasticities models in mind, which are based on insular economies from the past rather than open economies today. However, unlike the industrial economies after the WWII, now countries are much more open with a greater trade component and impressive inflows and outflows of capital. Notably, open economies react differently to exchange rate changes than insular ones do. McKinnon (1990) and McKinnon and Ohno (1997) have shown already that in open economies, exchange rate changes may have unpredictable effects on trade balances. In other words, with the correct setup of open-economy models, depreciation may not improve the trade balance and appreciation may not worsen it.

This paper in particular traces out the impact effects of exogenous exchange changes on open creditor/debtor economies when income and absorption are endogenously determined. It reveals that the combination of wealth effect, investment effect, together with indirect investment effect (in the East Asian region) increases the complexity of forecasting current account movement accompanying any exchange rate change. Except for the case when a debtor economy depreciates its currency against the dollar and suffers a foreign exchange crisis that depresses the economy, it is impossible to predict the net trade balance effect of a depreciation or appreciation because absorption may move “perversely” and offset the relative price effects.

McKinnon (2007) in this volume tackles the problem the other way around. Suppose government(s) act exogenously to change domestic absorption to correct a trade imbalance, but the exchange rate is left to be determined endogenously. He then shows that an improvement in the trade balance need not be associated with a devaluation, as conventional theory would have it.

2. Literature review

Like many other subjects in economics, economists have yet to reach an agreement over whether equilibrium in the balance of payments can be reached by exchange rate changes. But unlike other projects that require economists and politicians to work together, in this case, the misconception of adjusting trade balances through exchange rate movements can be largely attributed to economists, not politicians. Most of the economists who believe that exchange rate changes systematically affect trade balances acquired such thinking from the conventional elasticities model of the balance of trade, which is still being taught in undergraduate economic courses today.

Created in the 1930s and still widely accepted, the elasticities approach is central to many Keynesian (Meade, 1951) and monetarist models (Friedman, 1953; Johnson, 1958). According to these models, the exchange rate is assigned to address external balance while government expenditures are assigned to internal balance and full employment. However, this type of model is based on the assumption that exchange rate policies can be separated from monetary policies. In other words, it is assumed that when a discrete exchange rate change takes place, the domestic price level can remain undisturbed because the money supply is unaffected. In some circumstances, this may be true. For example, among the industrial countries after World War II, when capital movement was strictly limited and trade was less prevalent, this separability in policy was possible. In that case, a currency depreciation may lead to a reduction in trade deficit and an appreciation an improvement in trade balance.

However, no one will deny that today industrial economies and emerging market economies are much more open than 50 years ago. Without the insular assumption, the elasticity-type of models is no longer valid in predicting the consequences of exchange rate changes (McKinnon, 1990; McKinnon and Ohno, 1997). Nonetheless, economic scholars have yet to update their framework of thinking when they naturally associate currency depreciations with current account

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