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Inflexibilities and the trade account

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What can policymakers do to redress the global imbalances? This column presents evidence from 18 European countries over the past 60 years. It finds that while permanently fixed nominal exchange rates often result in large and lasting trade imbalances, these imbalances usually reflect a difference in trade competitiveness that can be addressed through structural and macroeconomic policies.

Imbalances in bilateral trade relationships have aroused considerable interest (Claessens et al. 2010). It made headlines at the most recent G20 ministerial level meeting, and it is sure to be on the agenda at the G20 Leaders' Summit in Seoul next week. One key concern is that pair-wise trade relationships have turned into one-way streets. And indeed, some large bilateral imbalances appear to be of increasing importance for some countries' overall trade balance.

A prominent example is the trade deficit between the US and China, which increased from virtually zero in the mid-1980s to more than $225 billion in 2009, accounting for almost half of the total US trade deficit. But there are other examples, including that of Italy, where the trade deficit with Germany has risen considerably within the last decade and now exceeds the country's overall deficit in external trade.

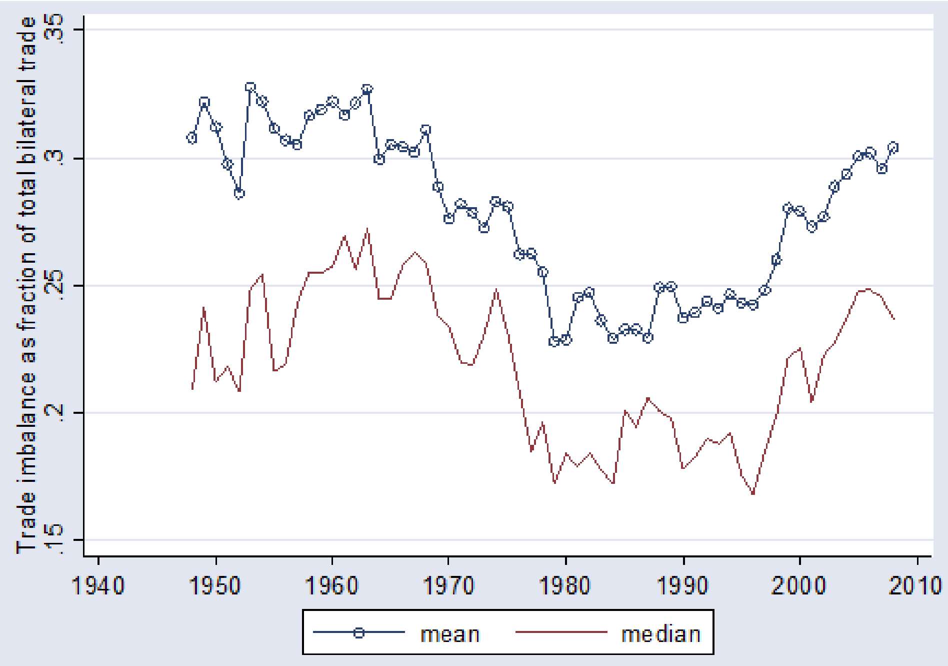
The question is whether there is anything intrinsically wrong with such developments. In fact, there is no economic reason to assume that a bilateral trade relationship should be balanced. Yet despite this, the emergence of large and persistent trade imbalances is often interpreted as prima facie evidence of underlying rigidities or distortions. For example, protectionist measures can bias trade in favour of a particular country. Similarly, distortionary policies could delay a country's external adjustment to shocks. Also, fixed or managed exchange rates may slow corrections of the real exchange rate.

In recent research (Berger and Nitsch 2010), we examine imbalances in intra-European trade and identify several new stylised facts that can add to the discussion on the effect of inflexibilities on trade. Specifically, we examine the patterns of trade between a sample of 18 European countries, some of which have adopted the euro as their common currency (and thereby permanently fixed the nominal exchange rate), over the period from 1948 through 2008.

We find that trade imbalances – measured as the fraction of deficits and surpluses in total bilateral trade – are indeed considerably higher when nominal exchange rates are inflexible. Figure 1 provides some illustrative evidence. The figure graphs the evolution of absolute trade imbalances in our sample over time. Interestingly, trade imbalances display a strong U-shaped pattern. There were relatively large bilateral trade imbalances in the Bretton Woods era, followed by a period of moderate imbalances in the 1970s and 1980s, and a renewed increase in imbalances since the mid-1990s.

Taken at face value, this pattern is consistent with the hypothesis that a fixed exchange-rate regime is associated with larger trade imbalances. More importantly, when we examine trade balances for various groups of countries, the U-shaped pattern applies most strongly to trade between Eurozone member countries, while trade between non-members displays no clear tendency over time.

Figure 1. Bilateral trade imbalances over time



Notes: The figure graphs the absolute difference between a country's exports and imports with a partner as a fraction of total bilateral trade (exports plus imports) for a sample of 18 European countries. Data are taken from the IMF's Direction of Trade Statistics.

Regression analysis strongly confirms our visual observations. Moreover, since our estimates control for various sets of country-specific and pair-wise fixed effects, we can be confident that the larger imbalances are not (only) the result of enduring asymmetries in trade competitiveness between a given pair of countries or the consequence of trends in the competitiveness of specific countries against all others. High imbalances also seem to have come along with a higher degree of persistence of these imbalances, which can be partially linked to labour market inflexibility. The pace of adjustment of trade imbalances is typically slower when nominal exchange rates cannot be adjusted and a country's labour and product markets are rigid and inflexible.

Reviewing the direction of pair-wise trade imbalances, we find that bilateral trade surpluses are decreasing in the real exchange rate, decreasing in growth differentials, and increasing in the relative volatility of national business cycles. Also, countries with relatively higher fiscal deficits and less flexible labour and product markets exhibit systematically lower trade surpluses than others. It seems reassuring to note that many of these effects are particularly developed among Eurozone member countries.

Our findings entail both bad and good news for policymakers in the Eurozone. On the negative side, permanently fixed nominal exchange rates do come at the cost of large and lasting trade imbalances. On the plus side, these imbalances can be addressed through structural and macroeconomic policies.

References

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