Press Points for Chapter 3: ***Exchange Rates and the Adjustment of External Imbalances***

World Economic Outlook, April 2007

Prepared by Roberto Cardarelli and Alessandro Rebucci
Research Department

Key Points

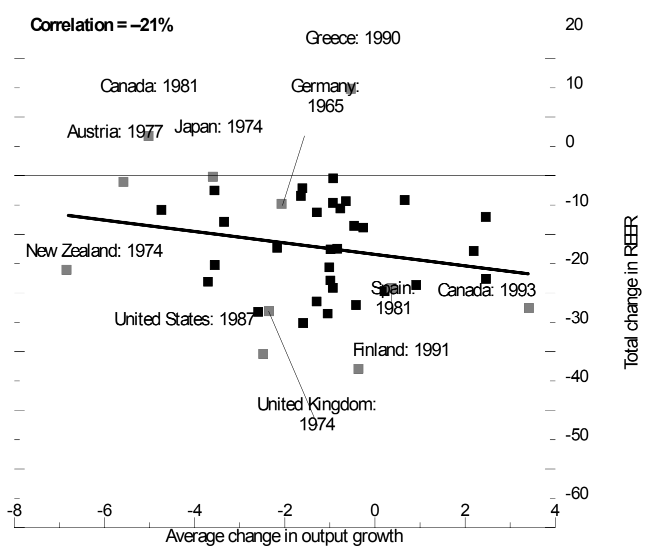
- **Changes in real exchange rates can play a helpful role alongside the rebalancing of demand in the adjustment of global imbalances. A real depreciation of the U.S. dollar and real appreciations of the currencies of countries with current account surpluses could facilitate the narrowing of imbalances by reducing the output costs that may otherwise occur during the adjustment period because of demand shifts.**

- **The U.S. trade balance may be more responsive to real exchange rate movements than often assumed in the literature.**

- **The responsiveness of trade to changes in the real exchange rate is greater the more flexible the economy**.

Movements of real exchange rates can help smooth the rebalancing of demand involved in the narrowing of external imbalances. An analysis of 42 episodes of large and sustained reversals of current account deficits over the past 40 years suggests that advanced economies have experienced less of a reduction in GDP growth when their currencies experienced a relatively large depreciation (see Figure).

Advanced Economies: Total Change in Real Effective Exchange Rate and Average Change in GDP Growth During Deficit Reversals



In addition to movements in real exchange rates, domestic policies matter for external adjustment. In particular, historical evidence suggests that increases in saving rates and strong fiscal consolidation in deficit countries have allowed investment and growth rates to be better sustained during the adjustment period.

For both advanced and emerging market countries, reversals of external surpluses have tended to involve real appreciations of their currencies. Moreover, the narrowing of surplus positions has generally been accompanied by a pickup in domestic demand, associated with more expansionary monetary and fiscal policies.

The U.S. trade balance may be more responsive to changes in the real value of the U.S. dollar than often assumed. Standard empirical trade models tend to underestimate U.S. trade volume responses to real exchange rates as they fail to account for large differences in response across sectors (aggregation bias), and for the degree to which imports embody domestically produced intermediate products (vertical integration bias). Moreover, long-run U.S. trade price elasticities have tended to increase over time, reflecting greater competition among firms in an increasingly globalized economy. Specifically, the analysis in the chapter finds that a real U.S. dollar depreciation of less than 10 percent could bring about a 1 percent of GDP narrowing in the U.S. trade deficit. This compares to estimates commonly found in the economics literature that a 10–20 percent real dollar depreciation would be needed for such a reduction in the trade deficit.

The responsiveness of trade to changes in real exchange rates is greater the more flexible the economy. Changes in real exchange rates that are consistent with a given amount of external adjustment will be larger for economies where it is more difficult for firms to enter and exit trade—either because of rigidities in product and labor markets, or because of trade protectionism.