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The J-curve in the emerging economies of Eastern Europe

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Abstract

Devaluation or depreciation of a currency worsens the trade balance before improving it, resulting in a short-run deterioration of the trade balance. In January 2009, most of the emerging economies of Eastern Europe, which are characterized by a high level of inflation, experienced a sharp increase in inflation. This article uses a panel vector autoregressive model to examine the short-run effects of devaluation on the trade balance in the emerging economies of Eastern Europe. The results show that devaluation leads to a short-run deterioration of the trade balance, which is consistent with the J-curve hypothesis. The results also show that the J-curve effect is more pronounced in countries with a high level of inflation. The results have important implications for policymakers in emerging economies of Eastern Europe.

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Notes

¹ Following studies investigate the reasons for such appreciation: Kemme and Teng, [2000](#); Dibooglu and Kutan, [2001](#); Égert, [2002](#); Égert et al., [2002](#); Bulíř and Šmídková, [2005](#); De Broeck and Sløk, [2005](#). Égert ([2003](#)) provides a survey of this literature.

² For a review of trade policy in transition economies, see Drabek and Brada ([1998](#)) and Hare ([2000](#)).

³ See Kočenda ([2001](#)) and Kutan and Yigit (2004, 2005) for evidence of price convergence in transition economies.

⁴ For a comprehensive review of the development in exchange rate policies in these economies, see Kočenda and Valachy ([2005](#)).

⁵ Some related work study pass-through of exchange rates to inflation rates in some selected transition economies (Billmeier and Bonato, [2004](#); Coricelli et al., [2005](#); Korhonen and Wachtel, [2005](#)).

⁶ The ratio is used to make the measure of trade balance unit free (Bahmani-Oskooee, [1991](#)). For theoretical derivation of the reduced form see Rose and Yellen ([1989](#)).

⁷ We note that data on real effective exchange rates in transition economies is hard to obtain. In this article, we use CPI-based real effective exchange rates due to lack of uniform PPI-based real effective exchange rates for our sample countries. In his investigation of the equilibrium exchange rates of Bulgaria, Croatia, Romania, Russia, Ukraine

and PPI. His results go to the level analysis, Égert ([2005](#)) uses real bilateral exchange rates based on the potential bias that may exist in the inflation rate. However, the inflation rate may reflect more the

⁸ The three countries are the Czech Republic, Romania, and Ukraine.

⁹ Note that in most cases income variables carry significant coefficients signifying the importance of economic activity in influencing the trade balance.

¹⁰ Note that this new definition of the J-curve has also received empirical support by Bahmani-Oskooee and Ratha ([2004b](#), [2004c](#)) who considered the US trade balance with her 18 developed and 13 developing trading partners. They provided support for this new definition in a total of 18 cases.

¹¹ Other articles dealing with currency depreciation and trade flows for other countries include Briguglio, (1990); Cushman, ([1990](#)); Tegene, ([1991](#)); Buluswar et al. ([1996](#)); Rehman et al., ([1997](#)); Nachane and Randae, ([1998](#)); Miljkovic et al., ([2000](#)); Kyereme ([2002](#)); and Berument and Dincer ([2005](#)).

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