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► Volume 41, Issue 20 ► The J-curve in the emerging economies of ....

Original Articles

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 J-curve pattern. A new definition of the hypothesis implies a short-run deterioration combined with the long-run improvement. By using monthly data over the January 1990–June 2005 period from 11 east European emerging economies, most of which are the new European Union (EU) members or the EU candidate countries, this article uses the bounds testing approach to cointegration and error-correction modelling and finds empirical support for the J-curve hypothesis in three countries of Bulgaria, Croatia and Russia. The results have important implications for policymakers involved in economics in terms of using exchange rate policy as a policy device to achieve real convergence toward EU standards.

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 Turkey, Égert (2005) uses real exchange rates based on CPI and PPI. His results generally hold for both definitions of real exchange rates. In his panel analysis, Égert (2005) also employs CPI-based real exchange rates. Although Égert (2005) uses real bilateral rates against the euro and the US dollar, we use real effective exchange rates based on major trading partners. Use of the latter may reduce the potential bias that may be induced by using CPI rates of a particular transition economy which include the impact of regulated prices, especially during the early stages of the transition. However, the price regulations are gradually relaxed during our sample period, Moreover, the CPIs of major trading partners are not as regulated, and they reflect more the importance of tradables than the CPIs in transition economies.

[8] The three countries where there is no significant lag coefficient at all are 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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Source: Journal of Comparative Economics

Equilibrium Exchange Rates in Transition Economies
Source: International Monetary Fund Staff Papers

The effectiveness of devaluation: A general equilibrium assessment with reference to Greece
Source: Journal of Policy Modeling

The J-Curve: Evidence from East Asia
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