Research says falls in housing and equity prices, not exchange rates help reduce US trade imbalances

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Researchers at the University of Warwick and the European Central Bank have just published research that shows falls in US asset prices such as housing and equities have a substantially more important role for reducing US trade imbalances than changes in the US dollar exchange rate.

Their paper "Asset Prices, Exchange Rates and the Current Account," presented this month at the Royal Economic Society Conference at the University of Warwick, looks at the relationship between asset prices, exchange rates and the trade balance in the US over the period 1974-2005.

A number of scholars and policy makers believe that a large Dollar exchange rate depreciation is needed to increase US exports and, hence, reduce the trade and current account.

However the researchers; Luciana Juvenal of the University of Warwick, Professor Lucio Sarno of Warwick Business School at the University of Warwick, and Marcel Fratzscher of the European Central Bank, found that equity market shocks and housing price shocks had by far the greatest effect on reducing the US trade imbalance accounting for up to 35% of the movements of the US trade balance. By contrast, shocks to the real exchange rate of the US dollar explained less than 5% of such movements and exerted only a temporary effect on the US trade balance.

Warwick Business School Researcher Professor Lucio Sarno said “Our findings suggest that a sizeable real depreciation of the US dollar may not be an inevitability for an adjustment of today’s large current account imbalances, and that other factors, in particular global asset price changes, could be an equally or even more potent source of adjustment.”

Luciana Juvenal of the University of Warwick said: “These results underline the importance of wealth effects, stemming from asset price developments, as drivers of today’s global current account imbalances. The rise in asset prices over the past decade has in particular increased expected income of households in the United States and, therefore, raised their consumption. At the same time, investment has been facilitated in response to this higher demand and firms have found it easier to finance investment opportunities, thus overall worsening the US current account position. Significant falls in US asset prices, and equally stronger increases in asset prices in the rest of the world, will thus have the opposite effect and reduce trade imbalances.”

The researchers show that a depreciation of the US dollar worsens the US trade balance slightly upon impact (consistent with a J-curve effect). After this initial reaction, the trade balance improves but the magnitude of the effect is fairly small. For instance a 1.2% real depreciation of the US dollar raises the US trade balance by about 0.06% of US GDP. This implies that even a relatively high real depreciation of the US dollar, for instance by 10%, would improve the US trade balance by a modest 0.5%.

The researchers found that both equity shocks and housing price shocks have larger, and more persistent effects on the US trade balance than a real exchange rate shock. A positive relative equity shock of 10% lowers the US trade balance by 0.9%. Moreover, relative equity market and housing price changes in particular throughout the 1990s have been substantially larger than those for real exchange rates.

Source: University of Warwick