

# EXCHANGE RATE AND TRADE BALANCE RELATIONSHIP: THE EXPERIENCE OF ASEAN COUNTRIES

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## Abstract

This study addresses the question of whether exchange rate changes have any significant and direct impact on trade balance. By examining the trade balances between ASEAN-5 countries and Japan for the sample period from 1986 to 1999, this study found that the role of exchange rate changes in initiating changes in the trade balances has been exaggerated. As such, an alternative explanation to the observed behaviour of ASEAN-5 trade balances in the selected sample period has been postulated. In particular, we propose that trade balance is affected by real money, rather than nominal exchange rate. A mathematical framework that provides theoretical background to our proposition is presented. Our empirical data analysis suggests that the real money effect proposition could consistently explain the observed trade balances in Malaysia, Singapore, Thailand and the Philippines during the period of study, with respect to Japan. Thus, in order to cope with trade deficits, the governments of these ASEAN countries might resort to policy measures focusing on the variable of real money.

*Keywords:* Exchange rate; Trade balance; Real money; Purchasing power parity; ASEAN-5 Economies.

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## I. INTRODUCTION

Exchange rate is one of the important prices in an open economy since it affects so many business, investment and policy decisions. Thus, it is not surprising to learn that the study of exchange rate has been one of the most important areas of economic research over the past few decades. This body of research has experienced tremendous growth, especially in the post-Bretton Woods era in which foreign exchange rate has been highly volatile after the inception of the floating exchange rate regime in 1973.

One of the areas of research that has drawn the attention of researchers is the exchange rate-trade balance relationship. The elasticity model of the balance of trade (Krueger, 1983) has shown the existence of a theoretical relationship between exchange rate and the trade balance. Empirically, various studies have been conducted to assess the influence of exchange rate on trade balance, with the objective of providing valuable inputs to policy makers on the effectiveness of exchange rate policy such as devaluation-based adjustment policies (effected through nominal exchange rate) to balance a country's foreign trade (see, for example, Greenwood, 1984; Himarios, 1989; Rose and Yellen, 1989; Bahmani-Oskooee, 1991; Mahdavi and Sohrabian, 1993; Arize, 1994; Buluswar *et al.*, 1996; Rahman and Mustafa, 1996; Rahman *et al.*, 1997; Wei, 1999; Baharumshah, 2001; Bahmani-Oskooee, 2001; Lal and Lowinger, 2002; Singh, 2002). In theory, nominal depreciation (appreciation) of