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.

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