

## External rebalancing is not just an exporters' story: real exchange rates, the non-tradable sector and the euro

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Current account and trade balance deficits and surpluses have widened considerably since the mid 1990s on a global level. The US, the UK and Australia have been running large current account (CA) deficits and emerging market economies and commodity exporters have been posting significant surpluses. While the euro area as a whole has kept a broadly balanced CA with the rest of the world, the gap between surplus and deficit countries within the area has increased continuously and strongly during the last 10-15 years. The increasing divergence in current accounts has generally been associated with large real exchange rate divergences, which are likely to be reversed when current accounts are reversed.

The role played by the relative price of non-tradable goods and services in external adjustment processes has so far received little attention in the empirical literature. Policy makers instead tend to focus on the capacity of exporting companies to compete on the world market.

There are several reasons to pay particular attention to the role of non-tradables in external adjustment processes, particularly in the euro area. First, the standard, model-based inter-temporal approach of the current account ascribes an important role to the relative prices of tradables and non-tradables in trade balance adjustment. Second, increasing market integration both inside and outside EMU should have fostered convergence in traded goods' prices and increased co-movements of traded goods prices. Non-tradable prices could thus have become a more important determinant of real exchange rates. Third, non-tradable prices are of particular importance for external adjustment processes within the euro area. As shown in the paper, the suppression of nominal exchange rate fluctuations within the euro area has entailed a significant rise in the importance of non-tradable goods' prices in real exchange rate fluctuations of euro-area Member States.

Our paper shows that the non-tradable sector is important for trade balance adjustments. We find that the long-run relation between real exchange rates and the trade balance depends on the relative price of non-tradable to tradable goods and services. In other words, although tradable prices may affect the trade balance in the short-run, a sustained improvement in the trade balance will depend on a fall in the relative price of non-tradable goods and services.

We also check whether belonging to EMU makes any differences. The relation between the trade balance and prices holds for euro-area Member States as well as other OECD countries and has not been altered by the introduction of the euro.

We base our evidence on exploiting information from two different measures of the real effective exchange rate: one that includes exclusively tradable goods prices while the other includes both, tradable and non-tradable goods and services prices. We document a robust

long-run relation between the broader measure of the real effective exchange rate and the trade balance while no such link can be found with the narrow, tradable price based, exchange rate.

Our results suggest that, to facilitate current account adjustments, policy makers should think about measures aimed at improving the functioning of the non-tradable sector rather than concentrating solely on the health of the export sector.