

Effects of Exchange Rate Changes on International Trade Flows

S. Sundararajan

Introduction

The persistence of large payments imbalances in the face of considerable exchange rate variations have imparted new urgency to questions about the functioning of the balance of payments (BoP) adjustment process. The principle concern is that exchange rate changes appear to increase the risk and uncertainty in international trade which has been strengthened in recent years in response to increasing protectionist policy and sluggish growth of world trade. The increasing BoP difficulties experienced by India in recent years may be attributed to the above factors. Recent thinking in third world countries has suggested that given the dualistic structure and inflexible trade policies which feature the production process of developing countries, it is doubtful whether exchange rate changes would be effective.

Although the literature abounds in attempts to analyze the effects of exchange rate changes for the advanced countries, attempts to prove the same for India have been far and far between, the works of Da Costa, Gulati, Bhagwati and Onitsuka, Marwah and Aggarwal being exceptions. Evidence by Da Costa and Gulati suggests that devaluation did not lead to any improvement in the competitive position of India's exports. Bhagwati and Onitsuka results suggest that export growth had improved following devaluation. Marwah observed that the 1966 devaluation of rupee resulted in price increases of 15.7 per cent in 1967. Aggarwal's analysis of the determinants of the trade flows evidences a weak positive influence of devaluation on the BoP. Cooper's study indicates that, devaluation resulted in an increase in the prices of traded goods. Johnson and Heien have noted that a value of the price elasticity of imports between -0.5 and -1.0 is necessary for a successful devaluation. The evidence presented above including the effect of income and price elasticities, particularly price elasticities, are inconclusive and highly conflicting, ranging from very low to high elasticities, partly because of the imperfection of basic data on prices and difficulties faced in separating the effects of price changes from the effects of other changes such as those of income, demand or production. This has made it very difficult for the academicians to take a final decision on the controversy regarding the role of price elasticity on the trade flows. Be-