Abstract

This thesis examines the relationship between the real exchange rate and trade balance in eight countries with different level of development for the period 1991-2012. Using merely exchange rate to improve the trade balance refers to price-competitiveness and relies on the satisfaction of Marshall-Lerner condition. Additionally, we articulate the influence of other underlying factors, defined as “non-price competitiveness”, proxied with capital stock variable. A Vector Error Correction Model, based on Johansen’s Methodology was implemented in our two econometric specifications. The key findings of the classical trade model indicate that M-L condition is met in five countries and devaluation of domestic currency would improve their trade balance in long run. VECM results from second model, which extended the traditional imperfect substitutes framework to include non-price competitiveness factor, shows pronounced influence of product quality on trade balance, capital stock variable being significant in most of the cases. The results show that trade balance reacts to both changes in relative prices and product differentiation, thus non-price competitiveness factors must not be neglected by policy makers. Our findings also indicate the existence of J-curve pattern, as reflected by short-run coefficients, meaning that trade balance does not immediately improve after currency devaluation or change in product quality.

JEL Classification	F4, F11, F12, F14
Keywords	Exchange rate, Trade balance, Devaluation, Price and Non-Price Competitiveness, VECM, Marshall-Lerner condition.

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