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**Measuring the Effect of Exchange Rate Volatility on International Trade: A  
Cointegration Analysis of Transition Economies.**

By

Marie Stack, University of Limerick.

Fluctuating currencies, moving in response to market forces – a characteristic of the current international floating exchange arrangement – continue to exhibit significant volatility. Empirical results testing the hypothesis that exchange rate volatility, owing to continual changes in the relative prices of currencies, impacts on international trade are mixed to-date. However, this hypothesis has only had limited application to transition and developing economies. Given that the IMF recommends the growth of trade as the primary means by which these countries can grow and develop their economies, it is vital that currency fluctuations do not wield a negative impact on trade levels. This is particularly relevant, since, in general, transition economies share a lesser degree of sophistication in financial institutions and infrastructures, and thus financial instruments and hedging techniques, used for mitigating against exchange rate risk, are not commonly available.

This study seeks to impart an objective analysis on the direction and magnitude of the relationship between exchange rate volatility and export flows for three transition countries: South Africa; Brazil; and Pakistan. The sample size for each country, although subject to data availability, incorporates the use of interpolation of some observations so as to ensure a sufficiently large time horizon is maintained for meaningful statistical inference (South Africa, 1977Q4 to 1996Q4; Brazil, 1986Q1 to 1999Q1; and Pakistan, 1978Q4 to 1999Q1). Recently developed econometric techniques are applied including the analysis of time-series properties, stationarity, cointegration, and, where appropriate, an error correction mechanism to the sample country observations in order to determine any causality effects between exchange rate volatility and export levels. Assessing the potential risks and costs associated with exchange rate volatility, and whether these can be mitigated by policy actions is essential for future growth of transition economies.