This PDF is a selection from a published volume from the National Bureau of Economic Research

Volume Title: NBER International Seminar on Macroeconomics 2009

Volume Author/Editor: Lucrezia Reichlin and Kenneth West, organizers

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-70750-4 (paper)

Volume URL: http://www.nber.org/books/reic09-1

Conference Dates: June 12-13, 2009

Publication Date: June 2010

Chapter Title: External Balance in Low-Income Countries

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Chapter URL: http://www.nber.org/chapters/c11921

Chapter pages in book: 265 - 322

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External Balance in Low-Income Countries

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I.   Introduction

This paper investigates empirically the external balance of low-income countries by offering a coherent analysis of determinants of medium- to long-term real exchange rates, current accounts, and net foreign assets and highlighting factors that are more likely to be specific to these countries. The rise and persistence of large external imbalances in recent years have renewed interest in this area from an empirical and theoretical perspective and have also highlighted the need for a multipronged approach to the analysis of external balances on the basis of multiple indicators. In this paper, the simultaneous analysis of the three aforementioned indicators of external balance allows us to check the consistency of the results across indicators, an effort generally absent in the literature. The focus on low-income countries aims at filling another gap. Although the literature on the determinants of the real exchange rate and of the current account is very vast, very few contributions focus specifically on low-income countries or account for features that are quite specific to—or more important for—this set of countries. Our analysis emphasizes factors such as structural policy and institutional distortions, access to special external financing, and a larger macroeconomic sensitivity to exogenous shocks. For the purpose of the empirical analysis, extensive efforts were required to create a wide database, which is unique in terms of the set of indicators and countries covered.

A large literature has based the analysis of medium-term determinants of current accounts on the standard intertemporal approach to the current account emphasizing saving and investment decisions (see, e.g., Chinn and Prasad 2003; Lee et al. 2008).[1] A more recent empirical literature has aimed at explaining the patterns of global imbalances that have

widened over the past decade as a function of financial crisis, financial development and distortions, and institutional variables (Chinn and Ito [2007] and Gruber and Kamin [2007] and, from a theoretical perspective, Caballero, Farhi, and Gourinchas [2008], Mendoza, Quadrini, and Rios-Rull [2009], and Gourinchas and Jeanne [2009]). Others have illustrated the role of labor market policies and exchange rate regimes in influencing the persistence and dynamics of the current account (Ju and Wei 2007; Chinn and Wei 2008) and the relationship between labor market, financial frictions, and fiscal policies in shaping the optimal current account responses to shocks (Blanchard 2007).

The literature on real exchange rates is vast, and we cannot do justice to all contributions. Broad surveys are offered by Froot and Rogoff (1995), Rogoff (1996) and, for developing countries, by Edwards (1989), Hinkle and Montiel (1999), and Edwards and Savastano (2000).[2] The traditional findings of Meese and Rogoff (1983) on the unpredictability of exchange rates at short horizons are still undisputed, and the literature has converged toward explaining the behavior of real exchange rates at medium- to long-term horizons as a function of fundamentals (see, e.g., Engel and West 2005; Engel, Mark, and West 2008). Empirical analysis of long-run real exchange rates is typically guided by steady-state relationships in models involving the intertemporal and intratemporal allocation of resources between tradable and nontradable sectors (Montiel 1999; Obstfeld and Rogoff 1999; Ricci, Milesi-Ferretti, and Lee 2008; Vegh, forthcoming).

A growing literature has uncovered the medium-term determinants of gross and net foreign assets, after the creation of the Lane and Milesi-Ferretti database of external positions (for the latest version, see Lane and Milesi-Ferretti [2007]). Lane and Milesi-Ferretti (2002b) offer a theoretical and empirical discussion of long-term determinants of the net foreign asset position. Faria et al. (2007) show that more open economies with better institutions have a greater equity share in external liabilities.

Few studies have focused on low-income countries with the notable exceptions of Edwards (1989) and Hinkle and Montiel (1999).[3] In this paper, we argue that low-income countries differ from other countries mainly along three broad dimensions, which simultaneously affect the current account, the real exchange rate, and the net external asset position: (i) structural policies or distortions, in particular those related to the capital account and the domestic financial system; (ii) exogenous shocks, in particular natural disasters (whose effect may depend on the degree of capital account openness) and terms of trade shocks; and (iii) official external financing (grants and concessional loans).

We believe that these factors are particularly important for our sample of countries. First, low-income countries face greater distortions—some of which are policy induced—than other countries. For example, capital account controls—which were prevalent for a large number of countries over the sample analyzed—may reduce the ability of low-income countries to borrow in order to bring consumption and investment forward, as required by a lower level of development or the occurrence of negative shocks. Capital controls may therefore affect domestic demand, the current account, the net foreign assets, and the real exchange rate.[4] Domestic financial liberalization, which occurred during the 1980s and the 1990s in many developing countries, may reduce borrowing constraints and boost investment, which would tend to lower the current account and the net foreign assets position and appreciate the real exchange rate. But financial liberalization may also raise private savings, which, everything else equal, would improve the current account and the net foreign assets position and depreciate the real exchange rate.

Second, low-income countries are in general more exposed to shocks than other countries and may—as a result of the lack of diversification of their production structure—experience larger macroeconomic consequences associated with these shocks (see, e.g., Easterly et al. 1993). For example, low-income countries are exposed to frequent terms of trade fluctuations associated both with their exports (e.g., main crop or natural resources) and with their imports (e.g., oil). Such terms of trade fluctuations affect the real exchange rate and the current account through income and intra- and intertemporal substitution effects. Moreover, low-income countries frequently experience natural shocks, such as droughts, floods, windstorms, and earthquakes, which have larger macroeconomic consequences than in high- and middle-income countries—including on the external position. Finally, wars and violent political transitions between regimes have often occurred in the historical sample. Such events, by disrupting investment, consumption, and capital flows, can have a bearing on the current account and the real exchange rate at a relatively short horizon.

Finally, capital flows are typically of a different nature in low-income countries than in other countries. A large part of their foreign borrowing is in the form of official development assistance (grants or concessional loans). Such capital flows do not respond to market incentives and often do not need to be repaid, thus contributing to financing larger trade deficits over the medium term. Finally, aid flows have often been associated with the risk of Dutch disease as resource transfers and are expected to lead to more appreciated real exchange rates in the short run by increasing

aggregate demand (Van Wijnbergen 1984). In the long run, however, the effect on the real exchange rate is uncertain, depending on the relative impact on the productivity of tradables versus that of nontradables (Torvik 2001).

To anticipate some of the results for the indicators that are more important for low-income countries, we find that domestic financial liberalization is associated with higher current account balances and net foreign asset positions, suggesting a positive effect on domestic savings. Capital account liberalization tends to be associated with lower current account and net foreign asset positions and more appreciated real exchange rates, as predicted by standard theories. Negative exogenous shocks tend to raise (respectively, reduce) the current account in countries with closed (respectively, opened) capital accounts pointing at the importance of capital account frictions in shaping intertemporal consumption-smoothing decisions. Finally, foreign aid is progressively absorbed over time through net imports and is associated with a more depreciated real exchange rate in the long run, a result that may reflect larger productivity gains in the non-tradable sector relative to the tradable one.

The paper is organized as follows. Section II reviews the theoretical literature on the determinants of the external balances. Section III presents the results of the empirical analysis. Section IV presents conclusions.

II.   Determinants of External Balance

This section mainly reviews the determinants of the real effective exchange rate and of the current account, with particular emphasis on factors that are important fundamentals for low-income countries. Toward the end of the section we will discuss the more limited literature on the determinants of net foreign assets (which generally follows intuitions similar to the current account). The main emphasis will be on the theoretical arguments that can guide our empirical analysis, but we will also highlight the empirical contributions related to each conceptual argument, in order to ease comparison with our results. Potential determinants are grouped into four main categories: (i) main determinants already identified in the literature (macroeconomic policies, predetermined characteristics, and stage of economic development); (ii) structural policies, distortions, and institutions; (iii) shocks; and (iv) external financing.

Economic theory underpins the relationship between the real exchange rate, the current account, and a number of macroeconomic variables. In principle, factors that affect the real exchange rate should also

affect the current account: for example, factors influencing aggregate demand will generally affect both the current account and the real effective exchange rate. However, theoretical foundations for the empirical analysis of the real exchange rate have usually been derived from long-run steady-state analysis of models with tradable and nontradable goods in the presence of balanced trade.[5] At the same time, empirical analysis of the current account has been underpinned by the intertemporal approach to the current account, often in single-goods models, hence without a meaningful exchange rate (Edwards 1989; Hinkle and Montiel 1999; Obstfeld and Rogoff 1999; Vegh, forthcoming). In discussing the various determinants, we will highlight the possible joint effects.

A. Macroeconomic Policies, Predetermined Characteristics, and Economic Development

Fiscal policy. In the absence of Ricardian equivalence, fiscal policy affects aggregate demand, national savings, and therefore the current account balance and the real exchange rate.[6] Empirically, Chinn and Prasad (2003) and Lee et al. (2008) find that the fiscal balance is significantly and positively associated with the current account in pooled ordinary least squares (OLS) regressions.[7] Fiscal policy affects also the real exchange rate through a composition effect in a multigood economy even in the presence of Ricardian equivalence (Obstfeld and Rogoff 1999). If government spending falls relatively more on nontraded goods than private consumption (which is often the case for government consumption), it will lead to an appreciation of the real exchange rate since the relative price of nontraded goods must increase in order to maintain internal and external balance (Hinkle and Montiel 1999; Vegh, forthcoming). Consistent with this prediction, the empirical literature tends to find a positive coefficient (see, e.g., De Gregorio, Giovannini, and Wolf 1994; Ricci et al. 2008).

Net foreign assets. Countries with initially higher net foreign assets can afford higher spending (above income flow)—and therefore a lower current account—while remaining solvent (Obstfeld and Rogoff 1999, chap. 2). However, in economies with uncertain horizon, nonzero steady-state current accounts are positively associated with steady-state net foreign assets (see Lane and Milesi-Ferretti [2002a], Chinn and Prasad [2003], and Lee et al. [2008] for consistent empirical evidence in pooled OLS regressions).[8] Moreover, in steady state, higher net foreign assets allow higher consumption of both tradable and nontradable goods while remaining solvent, implying a more appreciated real exchange rate (Lane

and Milesi-Ferretti 2002a, 2004; Ricci et al. 2008). This relationship may not hold in low-income countries experiencing debt relief: if an increase in debt is expected to benefit from debt relief in the future, lower net foreign assets resulting from the increase in debt may not be associated either with lower consumption needed to service external liabilities through trade surplus or with changes in the real exchange rate. The effect of such expectations cannot be disentangled in the data and would also be reflected in the coefficient of net foreign assets in current account and real exchange rate regressions.

Demographics. Under the life cycle hypothesis, a higher share of inactive dependent population reduces national savings and the current account balance and therefore results in a more appreciated real exchange rate. In an overlapping generations model, a higher share of working-age agents raises national savings, thus increasing the current account. Population growth and fertility have a negative effect on the current account and a positive one on the real exchange rate if they are correlated with the share of young inactive people in the population. These predictions are confirmed empirically in the analysis of the current account (see, e.g., Lee et al. 2008), of the real exchange rate (see Rose, Supaat, and Braude 2009), and of net foreign assets (see Lane and Milesi-Ferretti 2002b).

Stage of development and economic growth. Neoclassical theory predicts that countries at an early stage of development should import capital and borrow against their future income to finance their investment needs and smooth out consumption, given high marginal utility of consumption (Obstfeld and Rogoff 1999). Similarly, fast-growing countries with higher expected productivity gains should invest more, implying a deterioration of the current account.[9] Finally, high productivity growth in the tradable sector relative to the nontradable sector should be associated with a more appreciated real exchange rate (Balassa-Samuelson effect): an increase in productivity in the tradable sector relative to the nontradable sector, with respect to trading partners, will lead to higher wages in the tradable sector (whose price is given in world markets if the country is small) and subsequently put upward pressure on wages and prices in the nontraded sector. Choudhri and Khan (2005) and Ricci et al. (2008) find that a 10% increase in the productivity of tradables relative to nontradables tends to appreciate the real exchange rate by about 1%–2% on average. Moreover, higher income will result in an upward pressure on prices of nontraded goods relative to traded goods, as traded goods are priced on the international market, leading to a real exchange rate appreciation.[10] However, a good measure of relative productivity is not easily

available in low-income countries. Therefore, this paper uses real GDP per capita as a proxy variable, as in most of the literature. As this variable may not accurately capture the relative productivity effects—on the contrary, it averages out productivity in tradables and nontradables—the expected sign on this proxy is not clear.

B. Policy Distortions and Institutions

Domestic financial reforms. A more developed financial system facilitates investment and helps attract foreign capital, thereby lowering the current account balance and appreciating the real effective exchange rate.[11] A more developed financial system may also improve the current account balance and depreciate the real exchange rate if it stimulates domestic savings (McKinnon 1973; Edwards 1995).[12] Gourinchas and Jeanne (2009) model an open economy in which both investment and saving decisions are distorted by "wedges" affecting the return to capital. Their model predicts that financial liberalization can have ambiguous effects on the external position of a developing country: a reduction of the saving distortion tends to *reduce* capital inflows by increasing domestic savings, but a reduction of the investment distortion tends to *increase* capital inflows by raising capital scarcity.[13] Empirical analysis has usually relied on measures of financial development as a proxy for the degree of financial liberalization and has found at best weak effects on the current account (Chinn and Ito 2007; Gruber and Kamin 2007).

Capital account openness. Neoclassical theory predicts that, over the development process, capital account liberalization should be associated with a deterioration of the current account (capital inflows) and a real exchange rate appreciation in developing countries, and with an improvement of the current account (capital outflows) and a real exchange rate depreciation in advanced countries (Lucas 1988; Edwards 1989).[14] Moreover, a more open capital account allows countries to borrow against future income and therefore to run a lower current account balance when hit by a temporary negative income shock (Vegh, forthcoming). However, Kraay and Ventura (2000) show that, if the marginal unit of wealth is invested in the same way as the average unit of wealth, transitory positive income shocks will lead to a current account deficit (surplus) in countries with negative (positive) net foreign assets.

Institutions. Broad institutional characteristics such as the quality of property rights and contract enforcement can have first-order effects on the current account balance and capital flows. Countries with better institutions may be more able to attract a steady flow of foreign capital as

a result of lower expropriation risks and therefore can sustain lower current account balances and net foreign asset positions (Alfaro, Kalemli-Ozcan, and Volosovych 2007; Gruber and Kamin 2007). However, in countries with better institutions, the political process may produce exchange rate policies less likely to favor overvalued real exchange rates and therefore result in higher current account and net foreign asset positions. The same outcome may arise from better institutions generating an environment more conducive to saving.

Trade reforms. The effect of trade reforms on the current account and the real exchange rate is theoretically ambiguous (Edwards 1989). Trade reforms that are temporary (or perceived as temporary) may worsen the current account by reducing the price of imported goods relative to domestically produced goods (intratemporal substitution effect). The intertemporal effect is ambiguous: the current account should improve as a result of the income effect, but a lower price for today's consumption relative to future consumption negatively affects the current account balance (Ostry 1990).[15] The effect of trade liberalization on the real exchange rate depends on whether income or substitution effects dominate. As trade is liberalized, the increase in real income resulting from lower import prices tends to appreciate the real exchange rate.[16] However, trade liberalization may also shift demand away from nontraded to traded goods, resulting in a depreciation. A similar result would arise from the direct effect of liberalization (say tariff reduction) on the reduction of the domestic price of tradables. The evidence is generally in favor of the latter effect (see Goldfajn and Valdes 1999; Ricci et al. 2008).

Price controls and black market premium. Administered prices keep prices below the market level and are therefore associated with a more depreciated real exchange rate (see evidence in Ricci et al. [2008]). However, price controls may also take the form of a marketing board pushing domestic prices up, which would therefore be associated with a more appreciated real exchange rate. Finally, a black market rate that is more depreciated than the official exchange rate (i.e., a positive black market premium indicating expectations of a devaluation of the official rate) is likely to be associated with a more appreciated real exchange rate (based on the official rate, which is the prevalent basis for measuring real exchange rates) for given fundamentals.

C.   Shocks

Terms of trade. The effect of an improvement in the terms of trade is uncertain and mainly depends on whether the substitution or the income

effect dominates. An improvement in the terms of trade arising from an increase in the price of exports raises the current account, as part of the positive income shock is saved to smooth out consumption over time, and appreciates the consumer price index–based real exchange rate as the increase in domestic demand (associated with the income effect) bids nontraded goods' prices up (Ostry 1988; Edwards and Ostry 1992). However, an improvement in the terms of trade arising from a decrease in the price of imports may also result in a worsening of the current account and a real depreciation if agents substitute imported goods for domestically produced goods or for future imported goods (Obstfeld and Rogoff 1999; Vegh, forthcoming). If imports are used as intermediate inputs in production, the last effect on the real exchange rate would be compounded, as domestic goods produced with those imports would tend to experience a decline in price. Overall, evidence shows a positive effect on the real exchange rate from a terms of trade improvement (see Ostry and Reinhart 1992; Chen and Rogoff 2003; Cashin, Céspedes, and Sahay 2004; Ricci et al. 2008; for an analysis of the separate effect of import and export prices, see Christiansen and Tokarick [2009]).

   Natural disasters. A negative income shock positively affects the current account balance if national savings increase, or if investment falls relative to savings, as a consequence of the shock. However, the current account could worsen if the country can smooth consumption out by borrowing on international financial markets (Obstfeld and Rogoff 1999). Thus, we expect the effect of natural disasters to depend on the degree of capital account openness.[17] When considering the long-run relationship between the real exchange rate and its fundamentals, we may expect shocks not to play any role, since it is likely that they have only temporary effects.

D.   External Financing

Official aid. In the short run, a surge in aid could push up domestic prices and induce a real exchange rate appreciation since supply has a limited ability to respond to an increase in aggregate demand financed by aid. In the long run, however, the effect of aid on the real exchange rate is theoretically ambiguous, since aid flows may cause an increase (decrease) in the productivity of the nontraded goods sector relative to the productivity of the traded goods sector, hence leading to a real exchange rate depreciation (appreciation).[18]

   To empirically estimate the impact of aid on the current account, aid must be broken down into its two main components (grants and

concessional loans), given that they are accounted for in different parts of the balance of payments (the former enters the current account and the latter the financial account). Also, to the extent that aid flows are usually redistributed to private agents through government expenditures and are not intermediated by the domestic financial system, their effect on the external position is independent of the impact of domestic financial liberalization. Conceptually, and as a first-order approximation, aid flows can be modeled as exogenous transfers.

Grants. Countries receiving a steady flow of grants are able to sustain a lower trade balance in the medium term. Given that grants are accounted for in the current account section of the balance of payments, the current account should remain unchanged if a grant fully finances a deterioration of the trade balance. If, on the contrary, part of the grant is saved in the form of international reserves, the current account will improve.[19]

Concessional loans. Concessional loans allow financing of a lower current account in the medium term. Moreover, debt on concessional terms poses a measurement issue as it creates a gap between the nominal and the present market value of net foreign assets.[20] This paper examines the effect of net foreign assets when accounting for the present value of public and publicly guaranteed debt.[21] This valuable correction of course has limitations since, given data availability, the additional effect from expected future debt relief cannot be accounted for.

The literature on net foreign assets is more limited, in part because the empirical analysis was impaired by the lack of good data until recently (see Lane and Milesi-Ferretti [2007] for a second edition of their data set). Lane and Milesi-Ferretti (2002b) offer a theoretical and empirical discussion of the main determinants for advanced economies and developing countries. First, public debt tends to reduce net foreign assets, similarly to the effect of budget deficits on the current account. Second, a higher share of dependent population implies the need to run down savings (and thus reduce net foreign assets) in order to consume more. Third, the relation between income and net foreign assets is more uncertain. A positive relation is suggested by the standard development model in which poor countries borrow and rich countries lend but can also be derived in models with habit formation or nonlinearities in the utility function. However, a negative relationship with income may arise as a result of limited access to international markets or a high desire for precautionary saving in developing countries. Finally, richer countries tend to invest more in equity (see Faria et al. 2007), which is

more likely to offer a higher long-term return and result in higher net foreign assets.

III. Empirical Results

A. Data

The exercise required an extensive data-gathering and cleanup exercise. We constructed a data set containing 134 countries over the period 1980–2006 for various indicators. Countries used in the main analysis were classified on the basis of their income group. Our low-income country sample (see app. table A1) comprises "low-income" or "lower-middle-income" countries according to the World Bank classification and excludes emerging markets to make the sample as homogeneous as possible (China, Colombia, India, Indonesia, Pakistan, and Thailand). "High-income" and "higher-middle-income" countries (in the World Bank classification), including the six countries above, were mainly used as a comparator group of high-income countries. A summary statistic of the main data is provided in appendix table A2. A description of all variables is provided in the appendix. The number of low-income countries entering the regressions varies across specifications based on data availability for the specific indicators, but the largest low-income country set (used in the trading partner calculations and in regressions with standard fundamentals) includes 59 low- and lower-middle-income countries.

B. Analysis of Medium-Term Current Accounts

This subsection analyzes the medium-term relationship between the current account and a set of fundamentals. Following the existing literature, the estimations consist of an unbalanced panel of nonoverlapping 4-year averages over the period 1981–2005, with six observations for most countries.

1. Benchmark Current Account Regressions for Low-Income Countries[22]

Our preferred current account regressions for our sample of low-income countries are reported in table 1. In addition to country fixed effects, the regressions include traditional variables (see, e.g., Chinn and Prasad 2003; Chinn and Ito 2007; Lee et al. 2008) such as the fiscal balance,

Table 1
Medium-Term Determinants of the Current Account: Main Results

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Controls:									
Fiscal balance/GDP	.2432**	.2466**	.3392**	.3472**	.3966***	.3497**	.2528**	.3224***	.3680***
	(.0466)	(.0465)	(.0280)	(.0150)	(.0040)	(.0187)	(.0225)	(.0095)	(.0005)
Old-age dependency ratio	−.2673	−.2415	−.0140	−.2326	−.0324	.0194	−.4630	.1425	
	(.3881)	(.4375)	(.9617)	(.4602)	(.9174)	(.9495)	(.1263)	(.6296)	
Population growth	−1.6275**	−1.4663**	−2.6210***	−2.4801***	−2.4438***	−2.1768***	−1.1773*	−1.8436***	−1.7452***
	(.0209)	(.0410)	(.0009)	(.0045)	(.0011)	(.0024)	(.0715)	(.0052)	(.0082)
Initial net foreign assets	−.0103	−.0099	−.0045	−.0016	.0186	.0129	−.0043	−.0079	
	(.4115)	(.4371)	(.7014)	(.9022)	(.2035)	(.4030)	(.7245)	(.4899)	
Oil trade balance/GDP	.1820	.1892	−.0122	.0098	.0451	.0215	.1868	−.0004	
	(.1467)	(.1420)	(.9234)	(.9352)	(.7103)	(.8649)	(.1399)	(.9971)	
Income per capita (relative to U.S.)	.1017	.0372	.2680	.1912	.2358	.1632	.1110	.1747	
	(.6813)	(.8908)	(.2320)	(.4052)	(.2671)	(.5044)	(.6566)	(.4729)	
Per capita real GDP growth	.1446	.1263	−.0034	.0698	−.0252	−.0057	.1376	.0916	
	(.3078)	(.3849)	(.9798)	(.5963)	(.8490)	(.9668)	(.3218)	(.4897)	
New medium-term determinants:									
Terms of trade	.0228*	.0236*	.0345**	.0315**	.0336**	.0332**	.0260**ᶠ	.0269**	.0319***
	(.0955)	(.0905)	(.0191)	(.0267)	(.0165)	(.0263)	(.0499)	(.0340)	(.0074)
Aid flows/GDP	−.1130*								
	(.0636)								

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Concessional loans/GDP	-.3122* (.0695)				-.4754** (.0247)		-.5565*** (.0081)	-.4882** (.0127)
Net grants/GDP	-.0282 (.7365)				.2108* (.0616)		.2168* (.0543)	.1981* (.0571)
Domestic financial liberalization (initial)		.0343** (.0139)		.0276* (.0992)	.0326** (.0433)		.0241 (.1379)	.0244* (.0797)
Capital account liberalization (initial)			.0492** (.0156)	.0376* (.0862)	.0332 (.1190)		.0434** (.0371)	.0435** (.0289)
Natural disaster			.0349** (.0105)	.0101 (.5855)	.0032 (.8572)		.0359*** (.0064)	.0361*** (.0041)
Natural disaster × capital account (initial)			-.0605** (.0236)	-.0566** (.0385)	-.0495* (.0699)		-.0627** (.0145)	-.0654*** (.0071)
Natural disaster × initial net foreign assets				-.0357** (.0252)	-.0309* (.0826)			
Violent political transition						.0287*** (.0000)	.0280*** (.0006)	.0262*** (.0014)
Observations	223	219	143	143	139	223	139	139
R^2	.73	.73	.82	.83	.84	.75	.85	.84

Note: Robust panel regressions of the current account to GDP ratio on country fixed effects, a set of control variables (the fiscal balance to GDP ratio, demographic variables, the initial net foreign asset to GDP ratio, the oil trade balance to GDP ratio, income per capita relative to the United States, per capita real GDP growth), and a set of medium-term determinants of the current account including (i) aid flows, (ii) financial and capital account liberalization, and (iii) shocks (natural disasters, terms of trade fluctuations). The dependent variable and explanatory variables are averaged over 4-year periods (except when stated otherwise) and covering 1981–2005. Robust p-values are in parentheses.
*$p < .1$.
**$p < .05$.
***$p < .01$.

demographic variables (the old-age dependency ratio, population growth), the initial net foreign asset position, the oil trade balance, and variables related to the stage of development (GDP per capita relative to the United States and real per capita GDP growth). Most notably, the ratio of the fiscal balance to GDP in relation to trading partners and population growth remains strongly significant in our sample of low-income countries with the expected sign.

Our set of control variables also includes a measure of the terms of trade that has traditionally not been included in current account regressions. Our findings are consistent with the interpretation that income effects resulting from terms of trade fluctuations have a strong impact on the current account: a temporary improvement in the terms of trade tends to improve the current account as part of the increase in income is saved to smooth consumption over time.

Columns 1–7 report regressions in which we introduce—one by one or in groups—our new medium-term determinants of the current account, in addition to the previous set of medium-term determinants of the current account. Column 8 and 9 summarize our preferred results, either when maintaining standard determinants or when using a parsimonious specification with only significant variables.

Regarding official financing, an aggregate measure of foreign aid is significantly and negatively correlated with the current account.[23] The estimated coefficient implies that, for any $1.00 of aid, the current account deteriorates by about $0.10 during the same period. Consistent with theoretical predictions of normative models (see, e.g., Matsen and Torvik 2005), on average, a large share of aid is not immediately spent on net imports and is indirectly saved as foreign exchange reserves (Prati and Tressel [2006] and Berg et al. [2007] provide consistent evidence that macroeconomic responses to aid surges may limit the short-run absorption of aid in low-income countries).

As the two components of foreign aid (grants and concessional loans) are accounted for in separate parts of the balance of payments (the current account and the financial account, respectively), we present regressions separating these components in columns 2, 6, 8, and 9. The estimated coefficients imply that, on average, about 80% of grants are fully absorbed through an increase in net imports over a 4-year period, whereas only 30%–50% of concessional loans received are absorbed through net imports over the same horizon (see Prati and Tressel [2006] for a model of macroeconomic policy responses to aid flows).[24]

Domestic financial reforms are associated with higher current accounts, suggesting that these reforms boost domestic private savings

more than investment. This interpretation is consistent with the
McKinnon hypothesis (initially formulated by McKinnon [1973] and
also conceptualized by Fry [1995]), according to which a liberalization
of domestic banking systems in developing countries results in higher
saving rates by raising the return on financial savings.[25] The estimated
effect implies that shifting from complete financial repression to the
sample average level of liberalization would lift the current account
by 1.5% of GDP. Evidence consistent with this interpretation is shown
in appendix table A3, which suggests that real deposit rates increase
when countries liberalize their domestic financial systems.[26]

The opposite effect on the current account of concessional loans and of
domestic financial liberalization may be explained by the fact that aid
flows are typically *not* intermediated by the domestic financial system,
as discussed in the theory section (aid flows typically finance govern-
ment current expenditures and public investment). In addition, part of
aid flows, by being redistributed through transfers, temporarily increase
private agents' disposable income, thus raising private consumption and
savings.[27]

Exogenous negative income shocks (as proxied by natural disasters)
have a negative impact on the current account, as predicted by standard
theory, but only in countries with a fully open capital account.[28] In these
countries, a temporary negative income shock is associated with a dete-
rioration of the current account and with capital inflows, which is consis-
tent with smoothing of aggregate consumption through international
borrowing.[29] Since we are already controlling for official capital flows,
our estimate should be capturing the role of private capital flows.

On the contrary, natural disasters are associated with current account
improvements in countries with closed capital accounts. A possible ex-
planation is that these negative shocks trigger a procyclical increase in
saving (relative to investment) when there is no access to international
capital markets. An alternative explanation is suggested by the work
of Kraay and Ventura (2000), who show that, under certain conditions,
the marginal unit of savings following temporary income shocks is in-
vested as the average one, suggesting that a positive change in savings
should lead to current account surpluses in countries for which the real
return on foreign assets is higher than the return on domestic assets, but
would lead to deficits in countries with a lower return. This implies that
negative income shocks should lead to current account surpluses (defi-
cits) in debtor (creditor) countries because domestic investment falls
more (less) than savings following such shocks.[30] When interacting the
natural disaster variable with the initial net foreign asset position, we

obtain a negative and significant coefficient on the interaction term, which tends indeed to support the prediction of the Kraay and Ventura model, and a nonsignificant coefficient on the shock variable itself (col. 5). Controlling for aid, however, weakens this estimated effect of the portfolio composition (col. 6).

Another interpretation of this evidence is that the impact of capital account liberalization on the current account depends on income fluctuations: as discussed, when countries face negative income shocks, a more open capital account allows borrowing on an international capital market, which is consistent with consumption smoothing. However, in good times, capital account liberalization seems to be associated with capital outflows in low-income countries, which is consistent with the presence of financial repression during the sample (app. table A3 shows that six out of 11 developing countries covered exhibited real deposit rates below U.S. deposit rates in the 1980s).[31]

Turning to institutional factors, we find that violent political events tend to improve the current account, suggesting that political unrest may trigger significant capital flight.

2. Robustness

Our main baseline results are generally robust to the inclusion of various additional explanatory variables as shown in table 2. Column 1 allows for a dynamic effect of the current account by controlling for the lagged current account.[32] In our sample of low-income countries, we find limited persistence of the current account beyond a 4-year horizon. Column 2 shows that trade reforms (as measured by an index of average tariffs) have no additional explanatory power. In column 3, we split the terms of trade index into two components and show that export prices are strongly positively correlated with the current account, whereas import prices are weakly and negatively correlated with the current account: a weaker correlation for the latter is consistent with income effects and substitution effects of import price movements having opposite effects on the current account. Next, as shown in column 4, the results are robust to the inclusion of emerging markets classified as lower-middle-income countries in the sample (these countries are China, Colombia, India, Indonesia, Pakistan, and Thailand). Furthermore, our results are robust to the use of a broader measure of capital account liberalization (updated version of Quinn [1997]), as reported in column 5. In columns 6, 7, and 8, we consider alternative interaction terms with the index of capital account openness. In column 6, we control for an interaction between the fiscal

balance and the capital account index to test whether the effect of fiscal policy may depend on the capacity of private agents to offset fiscal policies by borrowing or lending in international markets. We find that, in our sample of low-income countries, the effect of fiscal policy on aggregate demand and on the current account is not significantly affected by the degree of capital account openness. However, the negative sign is consistent with standard theories, as it would imply a lower effect of the fiscal balance on the current account in countries with more open capital accounts. In column 7, we consider an interaction with population growth but again do not find any significant effect. Still, the negative sign on the interaction term is consistent with neoclassical theories according to which countries with a younger nonactive population are more able to borrow against future income when the capital account is open. Column 8 considers an interaction term with real per capita GDP growth; the positive sign of the interaction term, although not significant, would suggest that countries with more open capital accounts tend to run higher current account balances when growth is temporarily above its trend.[33]

3.   Are Low-Income Countries Different?

We expect low-income countries to differ from high-income countries because of their higher exposure to shocks, greater distortions, and different sources of external financing. Table 3 explores the extent to which various medium-term determinants of the current account have significantly different effects on the current account of low-income countries on the one hand and of high-income countries on the other hand.

Among standard determinants of the current account, we find that (i) the fiscal balance, (ii) the old-age dependency ratio, and (iii) initial net foreign assets have significantly different impacts on the current account in low-income countries relative to other countries. In particular, we find no significant association between the current account and the fiscal balance in high-income countries, a finding consistent with those of Isard and Faruqee (1998) and Chinn and Prasad (2003), who did not find any significant association in industrialized countries. This result is consistent with the hypothesis that Ricardian equivalence is more likely to be a reasonable first-order approximation of consumption and saving decisions in advanced countries than in other countries. The negative sign of the coefficient for the initial net foreign asset position in advanced countries is consistent with the standard intertemporal approach to the current account that predicts that initially richer countries can sustain lower current account balances in the medium term.

Table 2
Medium-Term Determinants of the Current Account: Robustness

Variable	(1)	(2)	(3)	(4)[a]	(5)	(6)	(7)	(8)
Fiscal balance/GDP	.3166**	.3083***	.3486***	.2568**	.3230***	.5104***	.3886***	.3597***
	(.0141)	(.0030)	(.0025)	(.0188)	(.0047)	(.0016)	(.0004)	(.0007)
Population growth	−1.4924*	−2.7107***	−1.6308**	−1.7432***	−1.8557***	−1.7513***	−1.4558**	−1.7485***
	(.0550)	(.0000)	(.0173)	(.0030)	(.0068)	(.0045)	(.0228)	(.0050)
Log(terms of trade)	.0289**	.0352***		.0249*	.0327***	.0304**	.0278**	.0323***
	(.0268)	(.0037)		(.0460)	(.0070)	(.0118)	(.0242)	(.0058)
Concessional loans/GDP	−.4185*	−.4808**	−.4343**	−.5318***	−.4468**	−.4681**	−.4340**	−.5076**
	(.0712)	(.0128)	(.0220)	(.0074)	(.0219)	(.0158)	(.0232)	(.0116)
Net grants/GDP	.1710	.1154	.1953*	.2328**	.1532	.1787*	.1754*	.1881*
	(.1446)	(.2816)	(.0552)	(.0332)	(.1860)	(.0737)	(.0933)	(.0675)
Violent political transition	.0265**	.0234***	.0272***	.0255***	.0269***	.0271***	.0244***	.0277***
	(.0119)	(.0068)	(.0009)	(.0033)	(.0026)	(.0019)	(.0036)	(.0002)
Domestic financial liberalization (initial)	.0317**	.0168	.0251*	.0415***	.0248*	.0244*	.0260*	.0235
	(.0355)	(.3297)	(.080)	(.0073)	(.0977)	(.0781)	(.0644)	(.1512)
Capital account liberalization (initial)	.0247	.0390*	.0432**	.0331		.0415**	.0488**	.0432**
	(.2917)	(.0621)	(.0297)	(.1038)		(.0384)	(.0198)	(.0291)
Natural disaster	.0350**	.0321**	.0355***	.0303***	.0329**	.0376***	.0380***	.0356***
	(.0124)	(.0330)	(.0036)	(.0071)	(.0269)	(.0032)	(.0027)	(.0038)
Natural disaster × capital account (initial)	−.0499*	−.0594**	−.0664***	−.0691***		−.0666***	−.0646***	−.0643***
	(.0788)	(.0235)	(.0056)	(.0041)		(.0067)	(.0079)	(.0071)
Lag of current account	.0145							
	(.8704)							
Trade liberalization index (initial)		.0002						
		(.9898)						
Export price index			.0431***					
			(.0041)					

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Import price index			−.0252* (.0679)				
Capital account liberalization (Quinn 1997)					.0345* (.0857)		
Natural disaster × capital account (Quinn 1997)					−.0487* (.0613)		
Fiscal balance × capital account						−.3019 (.3002)	
Population growth × capital account							−1.2912 (.1067)
Economic growth × capital account							.4167 (.1545)
GDP per capita growth							−.0867 (.6280)
Observations	121	134	139	172	137	139	139
R^2	.86	.84	.85	.80	.84	.85	.85

Note: Robust panel regressions of the current account to GDP ratio on country fixed effects, a set of control variables (the fiscal balance to GDP ratio, demographic variables), and a set of medium-term determinants of the current account identified in table 1. The dependent variable and explanatory variables are averaged over 4-year periods (except when stated otherwise) and covering 1981–2005. Additional control variables are added one at a time: a 4-year lag of the medium-term current account, an index of average import tariff, price indices for exports and imports, an alternative broader measure of capital account liberalization (based on an extension of Quinn [1997]), and interaction terms between the capital account liberalization index and (i) the fiscal balance, (ii) population growth, and (iii) per capital real GDP growth. Robust p-values are in parentheses.

[a]This column considers a broader country sample including emerging markets that are classified as lower-middle-income countries (China, Colombia, India, Indonesia, Pakistan, and Thailand).

*$p < .1$.
**$p < .05$.
***$p < .01$.

Table 3

	(1)		(2)		(3)	
Variable	LICs	HICs	LICs	HICs	LICs	HICs
A. Current Account Regressions with Different Slopes for Low-Income Countries and High-Income Countries						
Fiscal balance/GDP	.3224***	−.0811	.3176**	−.1198	.3173**	−.2111
	(.0099)	(.6449)	(.0147)	(.4662)	(.0144)	(.2773)
Old-age dependency ratio	.1425	−1.7237**	.0642	−1.8566***	.0595	−2.3592***
	(.6342)	(.0204)	(.8302)	(.0094)	(.8416)	(.0064)
Population growth	−1.8436***	.0618	−1.8460***	−.4686	−1.8461***	−1.6787*
	(.0055)	(.9532)	(.0075)	(.6304)	(.0073)	(.0965)
NFA/GDP	−.0079	−.0646**	−.0119	−.0734***	−.0121	−.0811***
	(.4956)	(.0171)	(.3098)	(.0048)	(.2972)	(.0062)
Oil balance/GDP	−.0004	.0369	−.0266	.1145	−.0282	.2615
	(.9971)	(.8395)	(.7997)	(.5277)	(.7861)	(.1923)
Relative income per capita	.1747	.2427*	.1163	.1309	.1127	.1151
	(.4787)	(.0783)	(.6525)	(.2933)	(.6612)	(.3977)
GDP per capita growth	.0916	−.2543	.1262	−.1471	.1283	−.1891
	(.4954)	(.2536)	(.3689)	(.5020)	(.3590)	(.3929)
Violent political transition	.0280***	.0687***	.0273***	.0651***	.0272***	.0589***
	(.0006)	(.0001)	(.0017)	(.0001)	(.0016)	(.0006)

	(1)	(2)	(3)	(4)	(5)	(6)
Log(terms of trade)	.0269**	.0654*	.0240*	.0486	.0238*	.0499
	(.0356)	(.0698)	(.0639)	(.1670)	(.0641)	(.1348)
Concessional loans/GDP	-.5565***	...	-.6426***	...	-.6479***	...
	(.0085)		(.0027)		(.0023)	
Net grants/GDP	.2168*	...	.2138*	...	.2136*	...
	(.0567)		(.0649)		(.0639)	
Domestic financial liberalization (initial)	.0241	.0288	.0170	.0200	.0166	.0031
	(.1424)	(.3535)	(.3194)	(.5018)	(.3294)	(.9292)
Capital account liberalization (initial)	.0434**	-.1145**	.1917***	...	.0916***	...
	(.0388)	(.0197)	(.0002)		(.0016)	
Natural disaster	.0359***	-.0021	.0353**	-.0284	.0352**	...
	(.0067)	(.9465)	(.0106)	(.3717)	(.0104)	
Natural disaster × capital account	-.0627**	.0853*	-.0544**	.1100**	-.0539**	...
	(.0153)	(.0824)	(.0460)	(.0170)	(.0467)	
Capital account liberalization (initial; all countries)	...			-.1765***		-.0781***
				(.0009)		(.0021)
Capital account liberalization × GDP per capita	...			.2288**		.2427**
				(.0199)		(.0129)
Observations	234	234	234	234	234	234
R^2	.83	.83	.83	.83	.82	.82

(continued)

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Table 3
Continued

Variable	(1)		(2)		(3)	
	LICs	HICs	LICs	HICs	LICs	HICs
	B. *F*-Tests of Equality (*p*-Values) of Coefficients across Income Groups for Regressions Reported in Panel A					
Fiscal balance/GDP		.06	.04		.02	
Old-age dependency ratio		.02	.01		.01	
Population growth		.13	.24		.89	
Net foreign assets/GDP		.05	.03		.03	
Oil balance/GDP		.86	.50		.20	
Relative income per capita		.81	.96		.99	
GDP per capita growth		.18	.29		.23	
Violent political transition		.03	.04		.09	
Log(terms of trade)		.31	.51		.46	
Domestic financial liberalization (initial)		.89	.93		.73	
Capital account liberalization (initial)		.00	…		…	
Natural disaster		.27	.06		…	
Natural disaster × capital account		.01	.00		…	

Note: In panel A, robust panel regression of the current account to GDP on a set of medium-term determinants of table1, col. 8. Independent variables are interacted with dummy variables for our sample of low-income countries and high-income countries. Sample and period averages are as in tables 1 and 2. Robust *p*-values are in parentheses. In panel B, H_0: coefficient of HIC = coefficient of LIC (*p*-value of *F*-test is reported).
*$p < .1$.
**$p < .05$.
***$p < .01$.

Surprisingly, we seem to find a negative association between the current account and capital account openness for more developed countries when they do not experience natural disasters (col. 1)—a finding seemingly inconsistent with the standard prediction of the neoclassical theory, as richer countries should experience capital outflows when opening up their capital account. Moreover, for this group of countries, we obtain a positive coefficient on the interaction term between the capital account openness variable and the natural disaster variable. It is likely that this result is due to the fact that the specification in column 1 was ideal for low-income countries but not for high-income countries; two possible explanations relate to the way income and capital account liberalization interact and the role of shocks. In column 2, we introduce an interaction term between the capital account openness variable and GDP per capita as a way to test more directly the prediction of neoclassical theory that capital should flow from more developed to less developed countries. We find a positive coefficient of the interaction term, which is consistent with the prediction of this theory, and the total effect of capital account liberalization on the current account is indeed positive for the richer countries.[34] It is also possible that natural disasters are not relevant from a macroeconomic perspective for high-income countries (see the nonsignificant coefficient on this variable for the higher-income group). In regression 3, we drop the natural disaster variable and the interaction term and show that the interaction of the capital account liberalization index with GDP per capita is consistent with the prediction of the standard development theory.

C.   Empirical Analysis of the Real Exchange Rate

This subsection investigates the long-run relationship between the real effective exchange rate and a set of fundamentals. The estimation relies on an unbalanced panel of annual data covering 1980–2006. Panel unit root tests show the unit root nature of the variables involved in the estimation, apart from the natural shocks (see table 4). Panel cointegration tests have been performed for the benchmark regressions of interest (col. 3 in tables 5 and 6) and reject the null of no cointegration.[35] Under the assumption of I(1) cointegrated variables, dynamic ordinary least squares (DOLS) with fixed effects provide—from the coefficients of the variables in levels—an estimate of a long-run cointegrating relationship between the real exchange rate and a set of fundamentals. As part of the DOLS specification, in addition to the variables in levels, we enter changes in right-hand-side variables and—given the short length of the sample—one lead and one lag of these changes.

Table 4
Panel Unit Root Test Statistics

Variable	Statistic[a]	
	Sample A[b]	Sample B[b]
Log of REER (INS)	−1.59	−1.57
Log of REER (PWT)	−1.82	−1.97
NFA to GDP	−2.02	−2.06
NFA to trade	−1.58	−1.39
NFA (with NPV debt) to GDP	−2.06	−2.03
NFA (with NPV debt) to trade	−1.83	−1.53
Relative productivity (log)[c]	−1.53	−1.22
Terms of trade goods (log)	−1.45	−1.36
Government consumption to GDP[c]	−1.99	−2.12[d]
Trade restrictions[c]	−2.04	−1.75
Administered agricultural prices[c]	−.79	−1.12
Max agricultural price intervention[c]	−1.26	−.96
Aid to GDP[c]	−2.19[d]	−2.07
Fertility[c]	−.54	−.57
Capital account liberalization[c]	−1.95	−1.85
Domestic financial liberalization[c]	−1.5	−1.5
Natural disaster	−3.66[d]	−3.52[d]
Constraint on executive	−.85	−.8
Public debt to GDP	−1.52	−1.53
Public debt to trade	−1.82	−1.87
NPV of external debt to trade	NA	−1.63

Note: REER = real effective exchange rate, NFA = net foreign assets, NPV = net present value.
[a]Test based on Pesaran (2007).
[b]Samples A and B refer to restricting the sample to having at least 14 or 20 observations per country, respectively.
[c]Indicates that the variable is constructed relative to the weighted average of the trading partners.
[d]Means reject null H_0 of unit root at 5% one-sided.

1.   Benchmark Real Effective Exchange Rate Regressions
     for Low-Income Countries[36]

Tables 5 and 6 report the preferred specifications for low-income countries with two different measures of real effective exchange rates. The first is the CPI-based one offered by the International Monetary Fund's Information Notice System (IMF-INS). The second one is constructed from the price relative to the United States as reported in the Penn World Table, then turned into a real effective exchange rate by applying the same weights employed in the calculation of the IMF-INS real effective exchange rate. Results are virtually identical, with few exceptions discussed below. The regression specifications include traditional variables such as the net foreign assets, productivity, government

Table 5

Real Effective Exchange Rate (IMF Definition) Regressions: Panel Dynamic OLS with Fixed Effects (Only Long-Run Coefficients Reported)

Variable	(1)	(2)	(3)	(4)
NFA (with NPV debt) to trade	−.0168	−.0175		
	(.2661)	(.2511)		
Relative productivity (log)[a]	−.1019	−.0770		
	(.3613)	(.4869)		
Terms of trade goods (log)	.3458***	.3455***	.3931***	.4353***
	(.0000)	(.0000)	(.0000)	(.0000)
Government consumption to GDP[a]	1.2667*	1.1259*	2.0271***	1.9688***
	(.0622)	(.0910)	(.0002)	(.0074)
Aid to GDP[a]	−2.2405***	−2.1679***	−1.6187***	−1.3812***
	(.0000)	(.0000)	(.0000)	(.0016)
Capital account liberalization[a]	.3152***	.2916***	.2978***	.4910***
	(.0025)	(.0056)	(.0011)	(.0000)
Trade restrictions[a]	.0975	.1003		
	(.2836)	(.2630)		
Administered agricultural prices[a]	−.0004	−.0223		
	(.9954)	(.7174)		
Max agricultural price intervention[a]	.0596	.0691	.0596	.0129
	(.2059)	(.1368)	(.1660)	(.8473)
Fertility[a]	.1239***	.1221***	.0979***	.1512***
	(.0000)	(.0000)	(.0000)	(.0000)
Natural disaster	−.0951*			
	(.0559)			
Black market premium (%)				.2547***
				(.0015)
Observations	522	522	609	338
R^2	.71	.70	.65	.78

Note: Robust dynamic OLS panel regressions with fixed effects of the real effective exchange rate (INS source) on net foreign asset (with NPV value of external debt) to trade ratio, log of relative productivity, terms of trade if goods and services, government consumption to GDP, aid to GDP (or its components: concessional loans and grants), capital account liberalization, trade restrictions, agricultural price reforms, fertility, natural disaster, and black market premium. Unbalanced panel with annual data 1980–2006. Robust p-values are in parentheses.
[a]Indicates that the variable is constructed relative to the weighted average of the trading partners.
*$p < .1$.
**$p < .05$.
***$p < .01$.

consumption, terms of trade, and trade restriction, but also low-income-country-specific variables such as aid flows and capital account liberalization. Moreover, demographics and price controls are likely to be very relevant for low-income countries, even though these factors have been shown to matter also in other samples (see, respectively, Rose et al. 2009; Ricci et al. 2008). Column 1 of both tables includes a dummy for natural shocks defined as before, given that low-income countries are widely affected by such natural occurrences. The results would hint to a negative

Table 6
Real Effective Exchange Rate (Penn World Table) Regressions: Panel Dynamic OLS
with Fixed Effects (Only Long-Run Coefficients Reported)

Variable	(1)	(2)	(3)	(4)
NFA (with NPV debt) to trade	.0094	.0087		
	(.4610)	(.5053)		
GDP per worker PWT (log)	−.4418***	−.4266***		
	(.0006)	(.0010)		
Terms of trade goods (log)	.1634**	.1600**	.1970***	.2040**
	(.0281)	(.0326)	(.0077)	(.0318)
Government consumption to GDP[a]	2.0186**	1.8770*	3.3371***	5.3549***
	(.0350)	(.0507)	(.0000)	(.0000)
Aid to GDP[a]	−3.2405***	−3.1855***	−2.0504***	−1.3181***
	(.0000)	(.0000)	(.0000)	(.0049)
Capital account liberalization[a]	.1746**	.1520*	.1984**	.3048**
	(.0418)	(.0850)	(.0233)	(.0265)
Trade restrictions[a]	−.0434	−.0258		
	(.6543)	(.7934)		
Administered agricultural prices[a]	−.0299	−.0650		
	(.6735)	(.3607)		
Max agricultural price intervention[a]	.0343	.0530	.1842***	.0574
	(.4661)	(.2462)	(.0002)	(.4864)
Fertility[a]	.1464***	.1484***	.1247***	.1072***
	(.0001)	(.0001)	(.0001)	(.0060)
Natural disaster	−.1549***			
	(.0057)			
Black market premium (%)				.4344***
				(.0000)
Observations	522	522	622	364
R^2	.75	.74	.69	.81

Note: Robust dynamic OLS panel regressions with fixed effects of the real effective exchange
rate (Penn World Table source) on net foreign asset (with NPV value of external debt) to trade
ratio, log of relative productivity, terms of trade if goods and services, government consumption
to GDP, aid to GDP (or its components: concessional loans and grants), capital account liberal-
ization, trade restrictions, agricultural price reforms, fertility, natural disaster, and black market
premium. Unbalanced panel with annual data 1980–2006. Robust p-values are in parentheses.
[s]Indicates that the variable is constructed relative to the weighted average of the trading partners.
*$p < .1$.
**$p < .05$.
***$p < .01$.

effect of these shocks on the real exchange rate. However, given that the
econometric nature of these [0, 1] indicators is uncertain (a panel unit root
test rejects the unit root hypothesis), in column 2 (and subsequent regres-
sions) we exclude this indicator.

Columns 3 drops insignificant variables and derives a benchmark re-
gression. Consistently with the previous literature, government con-
sumption is associated with a real exchange rate appreciation, which is
usually the case under the presumption that government spending is

spent on nontradables in a higher proportion than private spending. An improvement in the terms of trade appreciates the real exchange rate with effects similar to those found in the other sample of countries (see Ricci et al. 2008). Fertility is associated with an appreciation of the real exchange rate, as in Rose et al. (2009). The net foreign assets position is not significant, as possible expectations of debt relief may blur the intertemporal role of this variable in our sample of low-income countries. Overall productivity is not significant with the IMF-INS real exchange rate and is negative with the Penn World Table one (note that for data set consistency, the productivity indicator is based on GDP per worker from the Penn World Table data set in the second case). One possible explanation is that, in low-income countries, measures of overall productivity equally reflect both tradable and nontradable sectors' productivities, or even more the nontradable sector productivity than the productivity of the tradable one (the opposite assumption stands behind the standard presumption for using aggregate productivity as a proxy for the Balassa-Samuelson effect). Unfortunately, it was not possible to construct a better proxy for the Balassa-Samuelson effect despite extensive efforts.

With regard to variables specific to low-income countries, aid inflows (from Roodman [2006]) in the long run are associated with a more depreciated exchange rate, potentially indicating a positive effect on productivity in the nontradable sector relative to the tradable sector. Aid is generally considered to push up domestic prices (especially of nontradables), thus leading to a real exchange rate appreciation (Dutch disease) in the short run, that is, when the supply side of the economy has not had a chance to adjust. In the long run, however, an increase in aid would be consistent with a real exchange rate depreciation if it would raise productivity of nontradables relative to the productivity of tradables (Torvik 2001).[37]

Capital account liberalization is associated with an appreciation of the real exchange rate, suggesting that, in the long run, such liberalization promotes persistent net capital inflows. Price distortions are also somewhat significant. In particular, the presence of marketing boards (as captured by the indicator "max agricultural price intervention") is likely to keep prices high and thus appreciate the real exchange rate.

Column 4 of tables 5 and 6 includes the black market premium, which unfortunately halves the sample size. As real exchange rates are normally measured at official rates, the positive and significant coefficient is consistent with the standard interpretation that the presence of a black market premium usually signals an overvalued official exchange rate. Generally, in these circumstances, most public transactions

are done at the official rate, whereas private transactions tend to occur at the black market rate, so the actual average exchange rate is likely to be between the official and the black market rates. This would correspond to a coefficient between zero and one, which is indeed what we find. However, the sample size decreases substantially, which limits the usefulness of the regressions. Measuring correctly the exchange rate is an important issue that should deserve wide attention in real exchange rate analysis—especially when focusing on low-income countries that have traditionally been more prone to dual exchange rate systems and problems of measurements of price levels—and would require additional efforts in data collection.

2.   Are Low-Income Countries Different?

Low-income countries differ from high-income ones mainly because of the specific factors (distortions, financing, and shocks), but traditional factors do not show great difference when specific factors are included in the regression. However, neglecting the presence of the specific factors would lead to misspecifications, and even coefficients on traditional factors would appear different. Columns 1 and 2 of table 7 (panel A) present a specification typically used for high-income and higher-middle-income countries (see, e.g., Ricci et al. 2008) but estimated with separate coefficients for low- and lower-middle-income countries (LICs) and for high- and upper-middle-income countries (HICs). All coefficients appear to be significantly different (see panel B, col. 1). The next column in table 7 (panel A) shows a regression equivalent to the one in table 5, column 2—that is, the benchmark before dropping variables that have been found relevant for a broader sample of advanced economies—but again with different slopes for low-income countries and high-income countries.

   As this regression encompasses indicators that are relevant for both sets of countries, it may be the best one to assess the different roles of these indicators across the sample of countries. The difference in the coefficients of the traditional variables is now insignificant in most indicators (panel B, col. 2). Net foreign assets appear to play a different role in the two set of countries, which is not surprising given that a possible expectation of debt relief may reduce the relevance of this variable in low-income countries. The key low-income country factors (apart from fertility) seem to play a different role in the two samples, which is again not surprising given that these indicators are likely to be less relevant in high-income countries. Column 3 table 7 (panel A) shows the income

split for a regression equivalent to the baseline in table 5, column 3, and panel B presents the corresponding test of equality of coefficients; results are now somewhat different, but the reason may be that such a regression is tailored to low-income countries and is misspecified for the other group.

3. Robustness

The benchmark model for low-income countries is generally robust to alternative specifications. Tables 8 and 9 repeat in column 1 the benchmark derived in column 3 of tables 5 and 6 and then explore the robustness of alternative indicators. In particular, columns 2 and 3 allow for the terms of trade (respectively, in goods only or in goods and services) to be split into two components (price of exports and imports) and show that the effect is mainly due to the price of exports. This is something we would expect and is consistent with the results for the current account regressions (table 2): an improvement in the terms of trade from a decline in import prices may generate not only a positive income effect (increasing demand for domestic goods) but also an additional substitution effect away from domestic goods, thus with offsetting effects on the real exchange rate (see Christiansen and Tokarick [2008] for a broad theoretical and empirical analysis of the effect of the components of the terms of trade). Results for the other variables are quite consistent with the previous regressions.

4. Speed of Adjustment

In order to assess the speed at which the real exchange rate adjusts toward its long-run cointegrating relationship, we impose the estimated cointegrating relationship in an error correction specification. We construct the error correction term via the difference of the real exchange rate from the sum of the products of the fundamentals entering the baseline regression in table 5, column 3, times the corresponding level coefficients. We then run changes of the real exchange rate on the lag of the error correction term as well as on lagged changes of the real exchange rate and of the other right-hand-side variables entering the baseline. In the four specifications derived by entering progressively from one up to four lags, the robust OLS coefficient of the lagged error correction term hovered around 0.2, suggesting that a shock to the gap would have a half-life of about 3 years. We replicated the exercise with the alternative measure of real exchange rate (hence using table 6, col. 3) and obtained a somewhat

Table 7

	(1)		(2)		(3)	
Variable	HIC	LIC	HIC	LIC	HIC	LIC
	A. Real Effective Exchange Rate (IMF Definition) Regressions with Different Slopes for Low-Income Countries and High-Income Countries: Panel Dynamic OLS with Fixed Effects (Only Long-Run Coefficients Reported)					
NFA (with NPV debt) to trade	.0276***	.0074	.0847***	-.0165		
	(.0020)	(.6476)	(.0000)	(.2699)		
Relative productivity (log)[a]	-.1346**	.2087***	-.1235	-.1157		
	(.0350)	(.0028)	(.1336)	(.2598)		
Terms of trade goods (log)	.1023	.3811***	.1745**	.3325***	.1564**	.3938***
	(.1466)	(.0000)	(.0262)	(.0000)	(.0331)	(.0000)
Government consumption to GDP[a]	1.3367***	.1634	1.5695***	1.2225**	1.7819***	2.0246***
	(.0015)	(.7362)	(.0017)	(.0489)	(.0004)	(.0002)
Trade restrictions[a]	.3179***	.0474	.2767***	.0833		
	(.0004)	(.5393)	(.0048)	(.2646)		
Administered prices	-.1070***					
	(.0000)					
Administered agricultural prices[a]			-.2448***	.0283		
			(.0011)	(.5365)		
Max agricultural price intervention [a]			-.1081	.0789*	-.0417	.0591
			(.1006)	(.0558)	(.5501)	(.1187)
Aid to GDP[a]			3.3650**	-2.4081***	.7691	-1.6192***
			(.0373)	(.0000)	(.5668)	(.0000)
Fertility[a]			.1054**	.1213***	.1939***	.0970***

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	B. F-Tests of Equality (p-Values) of Coefficients across Income Groups for Regressions Reported in Panel A			
Capital account liberalization[a]	.0283	.2823***	.3209***	.2999***
	(.7224)	(.0046)	(.0001)	(.0008)
Observations	1,916	1,361	1,471	
R^2	.53	.72	.66	
NFA (with NPV debt) to trade	.2710	.9525		
Relative productivity (log)[a]	.0003	.1165		
Terms of trade goods (log)	.0020	.6628	.0175	
Government consumption to GDP[a]	.0678	.1168	.7432	
Trade restrictions[a]	.0221			
Administered prices		.0019		
Administered agricultural prices[a]		.0161		
Max agricultural price intervention[a]		.0006	.2043	
Aid to GDP[a]		.7801	.0818	
Fertility[a]		.0465	.0308	
Capital account liberalization[a]			.8620	

Note: In panel A, robust dynamic OLS panel regressions with fixed effects of the real effective exchange rate (INS source) on same determinants as the previous two tables. Independent variables are interacted with dummy variables for low-income countries and high-income countries. Columns 1 present standard determinants only. Columns 2 encompass determinants in col. 2 of the two previous tables. Columns 3 present determinants in col. 3 of the previous two tables. Unbalanced panel with annual data 1980–2006. Robust p-values are in parentheses. In panel B, p-values for the H_0: coefficient HIC = coefficient LIC.

[a]Indicates that the variable is constructed relative to the weighted average of the trading partners.

*$p < .1$.

**$p < .05$.

***$p < .01$.

Table 8

Real Effective Exchange Rate Regressions (IMF Definition) Regressions, Robustness: Panel Dynamic OLS with Fixed Effects (Only Long-Run Coefficients Reported)

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Terms of trade goods (log)	.3931***			.2578***	.4281***	.3766***	.3930***	.3871***
	(.0000)			(.0000)	(.0000)	(.0000)	(.0000)	(.0000)
Government consumption to GDP[a]	2.0271***	1.8930***	1.6995**	1.2982*	2.6090***	1.7860***	2.3317***	2.0402***
	(.0002)	(.0003)	(.0167)	(.0871)	(.0000)	(.0009)	(.0000)	(.0004)
Aid to GDP[a]	−1.6187***	−1.4091***	−1.5832***	−4.6194***	−1.8067***	−1.4648***	−1.9358***	−1.6471***
	(.0000)	(.0000)	(.0000)	(.0000)	(.0000)	(.0000)	(.0000)	(.0000)
Capital account liberalization[a]	.2978***	.2890***	.2594**		.3374***	.2611***	.2511***	.2816***
	(.0011)	(.0011)	(.0103)		(.0001)	(.0022)	(.0057)	(.0025)
Max agricultural price intervention[a]	.0596	.0657	.1616***	.0886**	.0501	−.0295	.0058	.0528
	(.1660)	(.1223)	(.0002)	(.0238)	(.2247)	(.4794)	(.8933)	(.2153)
Fertility[a]	.0979***	.0821***	.1100***	.1490***			.1156***	.1013***
	(.0000)	(.0005)	(.0003)	(.0000)			(.0000)	(.0000)
Price of exports – goods		.3698***						
		(.0000)						
Price of imports – goods		−.3754***						
		(.0000)						

Price of exports – goods and services		.1554*						
		(.0921)						
Price of imports – goods and services		−.0751						
		(.3470)						
Capital account liberalization (other)[a]			.0668					
			(.3459)					
Infant mortality rate (UN)[a]				.0052***				
				(.0001)				
Old-age dependency[a]					5.2828***			
					(.0000)			
GDP per worker PWT (log)						−.2360**		
						(.0255)		
Relative productivity (log)[a]							−.0363	
							(.6816)	
Observations	609	609	609	561	609	609	555	609
R^2	.65	.66	.61	.64	.64	.68	.68	.66

Note: Robust dynamic OLS panel regressions with fixed effects of the real effective exchange rate (INS source) on same determinants as previous two tables. Additional controls encompass splitting terms of trade in price of exports and of imports (either of goods only or of goods and services) and alternative measures of capital account liberalization, of demographics, and of productivity. Unbalanced panel with annual data 1980–2006. Robust p-values are in parentheses.

[a]Indicates that the variable is constructed relative to the weighted average of the trading partners.

*$p < .1$.
**$p < .05$.
***$p < .01$.

Table 9

Real Effective Exchange Rate (Penn World Table) Regressions Robustness: Panel Dynamic OLS with Fixed Effects (Only Long-Run Coefficients Reported)

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Terms of trade goods (log)	.1970***			.1098	.3453***	.2593***	.1892***	.2023***
	(.0077)			(.1327)	(.0000)	(.0000)	(.0092)	(.0045)
Government consumption to GDP[a]	3.3371***	3.0899***	2.8125***	2.1511**	4.0085***	2.8295***	3.4689***	4.0020***
	(.0000)	(.0000)	(.0002)	(.0230)	(.0000)	(.0001)	(.0000)	(.0000)
Aid to GDP[a]	−2.0504***	−1.5720***	−1.5319***	−3.9983***	−2.4248***	−1.6520***	−2.1860***	−2.6034***
	(.0000)	(.0002)	(.0006)	(.0000)	(.0000)	(.0001)	(.0000)	(.0000)
Capital account liberalization[a]	.1984**	.1995**	.2124**		.3337***	.1672**	.1747*	.1140
	(.0233)	(.0166)	(.0167)		(.0002)	(.0314)	(.0575)	(.1836)
Max agricultural price intervention[a]	.1842***	.2037***	.1958***	.2401***	.1764***	.0412	.1770***	.1095**
	(.0002)	(.0000)	(.0000)	(.0000)	(.0009)	(.3679)	(.0003)	(.0290)
Fertility[a]	.1247***	.1311***	.1553***	.1485***			.1364***	.1354***
	(.0001)	(.0000)	(.0000)	(.0000)			(.0002)	(.0001)
Price of exports – goods		.2490***						
		(.0012)						
Price of imports – goods		−.0875						
		(.3106)						
Price of exports – goods and services			.2331***					
			(.0060)					

Price of imports – goods and services		−.0715 (.3759)					
Capital account liberalization (other)[a]			.1540* (.0883)				
Infant mortality rate (UN)[a]				.0046*** (.0077)			
Old-age dependency[a]					6.3982*** (.0000)		
Relative productivity (log)[a]						−.0889 (.4985)	
GDP per worker PWT (log)							−.3678*** (.0029)
Observations	622	622	571	622	622	622	587
R^2	.69	.70	.74	.63	.70	.69	.70

Note: Robust dynamic OLS panel regressions with fixed effects of the real effective exchange rate (Penn World Table source) on same determinants as previous two tables. Additional controls encompass splitting terms of trade in price of exports and of imports (either of goods only or of goods and services) and alternative measures of capital account liberalization, of demographics, and of productivity. Unbalanced panel with annual data 1980–2006. Robust p-values are in parentheses.

[a]Indicates that the variable is constructed relative to the weighted average of the trading partners.

*$p < .1$.
**$p < .05$.
***$p < .01$.

higher speed of adjustment, in the order of 0.3, indicative of a half-life of about 2 years. These results are in line with the previous literature (see, e.g., Rogoff 1996).

D. Empirical Analysis of the Net Foreign Asset Position

This subsection investigates empirically the net foreign asset position of low-income countries. The estimation relies on an unbalanced panel of annual data covering 1980–2006. Again, panel unit root tests confirm the unit root nature of the variables involved in the estimation (see table 4), and panel cointegration tests performed for the benchmark regressions (table 10, col. 1) reject the null hypothesis of no cointegration (see the discussion of these tests in the previous section). Similarly to the real exchange rate regressions, the panel cointegration estimation is based on DOLS with fixed effects. In addition to determinants identified in the literature (public debt, demographics, and income per capita), we analyze the role of policy distortions (capital account and domestic financial liberalization) and of the quality of institutions.

1. Benchmark Net Foreign Asset Regressions for Low-Income Countries

Table 10 reports our preferred regression of the net foreign assets to trade ratio (col. 1).[38] Results are broadly consistent with those obtained in the analysis of the current account. Starting with the less common indicators, let us first note that domestic financial liberalization is associated with higher net foreign assets, again an indication (as discussed in Secs. II and III.B) that domestic financial reforms have a significantly larger positive effect on aggregate savings than on aggregate investment. Second, the relationship with capital account liberalization is negative in low-income countries (table 10) and positive in high-income ones (table 11), a result that is consistent with the current account regressions and with the standard neoclassical theory according to which developing countries should experience capital inflows when opening up to foreign capital. Finally, countries with better institutional characteristics also have higher net foreign assets, which may be explained by the argument that better institutions may facilitate the saving process, resulting in higher net foreign assets.[39]

Regarding the standard variables, we confirm a strong link between net foreign assets and public debt, demographic factors, and income.

In the long run, half of the increase in public debt is reflected in a reduction of net foreign assets. The effect is close to the one estimated by Lane and Milesi-Ferretti (2002b) for developing countries in the order of 0.5–0.8. The effect of public debt on net foreign assets is somewhat larger than the one of fiscal balance on the current account presented in Section III.B.[40] A higher share of dependent population is associated with lower savings and net foreign assets, a result that is also consistent with theoretical intuition and past evidence. The positive association of income per capita with net foreign assets in low-income countries is in line with the standard development model in which poor countries borrow (note, however, that Lane and Milesi-Ferretti [2002a] find the opposite result).

2.   Robustness

Robustness exercises are presented in the subsequent columns of table 10. The results are robust to using alternative measures of net foreign assets with matching alternative debt indicators (net foreign assets and public debt to GDP in col. 2 or net foreign assets and external debt both adjusted for the net present value of external debt in col. 3), as well as alternative measures of demographics, capital account liberalization, and relative income or productivity (cols. 3–7). Terms of trade shocks or other policy distortions such as trade restrictions and price controls in the agricultural sector do not seem to matter after controlling for other determinants (cols. 8–10).

3.   Are Low-Income Countries Different?

Table 11 presents the benchmark net foreign asset regression (table 10, col. 1) for high- and low-income countries in columns 1 and 2, as well as the test of equality of coefficients in column 3. The high-income group appears quite different for about half of the indicators and not too different for the other half. As mentioned, the most interesting result is the opposite coefficient for capital account liberalization, consistent with the fact that rich countries lend and poor borrow. Debt appears insignificant for the high-income sample, which is in line with the range of 0–0.2 found by Lane and Milesi-Ferretti (2002b) for this group of countries. A possible interpretation is that public debt is less likely to be foreign financed in higher-income countries than in low-income countries, possibly because of much deeper financial markets in more developed countries. The role of demographics, domestic financial liberalization,

Table 10
Net Foreign Asset Regressions: Panel Dynamic OLS with Fixed Effects (Only Long-Run Coefficients Reported)

Variable	NFA to Trade (1)	NFA to GDP (2)	NFA (with PV) to Trade (3)	NFA to Trade (4)	NFA to Trade (5)	NFA to Trade (6)	NFA to Trade (7)	NFA to Trade (8)	NFA to Trade (9)	NFA to Trade (10)
Public debt to trade	-.4566***			-.4240***	-.4369***	-.4084***	-.4764***	-.4840***	-.4686***	-.4610***
	(.0000)			(.0000)	(.0000)	(.0000)	(.0000)	(.0000)	(.0000)	(.0000)
Fertility[a]	-.3135***	-.0531**	-.0761		-.2997***	-.5563***	-.1375	-.3612***	-.4913***	-.2896**
	(.0028)	(.0260)	(.1597)		(.0035)	(.0000)	(.1316)	(.0026)	(.0001)	(.0119)
Relative productivity (log)[a]	1.5867***	.2829***	.5295***	1.6864***	1.8451***			1.1766**	1.7841***	1.3836***
	(.0016)	(.0019)	(.0050)	(.0026)	(.0003)			(.0316)	(.0008)	(.0039)
Constraints on executive	.2280***	.0293**	.0086	.2520***	.2221***	.1847***	.1944***	.2324***	.2504***	.2505***
	(.0000)	(.0109)	(.7005)	(.0000)	(.0000)	(.0000)	(.0000)	(.0000)	(.0000)	(.0000)
Domestic financial liberalization[a]	2.0003***	.2081**	.2147	2.0634***	1.6171***	1.3346***	1.6155***	1.2107**	1.8758***	2.2360***
	(.0001)	(.0458)	(.4030)	(.0000)	(.0001)	(.0009)	(.0009)	(.0223)	(.0006)	(.0001)
Capital account liberalization[a]	-1.4137***	-.1060	-.4333**	-1.3293***		-.7920**	-1.6001***	-1.5802***	-1.4892***	-1.1084**
	(.0011)	(.1886)	(.0436)	(.0030)		(.0498)	(.0003)	(.0004)	(.0042)	(.0191)
Public debt to GDP		-.5423***								
		(.0000)								
NPV of external debt to trade			-.8922***							
			(.0000)							
Old-age dependency[a]				-16.3720**						
				(.0192)						

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	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Capital account liberalization (other)[a]										
Income per capita (relative to U.S.)					−.4263* (.0948)					
GDP per worker PWT (log)						28.0763*** (.0000)	.8484** (.0498)			
Terms of trade – goods and services (log)								.3861 (.1988)		
Trade restrictions[a]									.5061 (.1425)	
Administered prices[a]										.4681 (.1833)
Max price of intervention[a]										.4551** (.0127)
Observations	610	590	612	610	653	599	610	539	554	566
R^2	.81	.84	.96	.82	.83	.82	.81	.82	.82	.81

Note: Robust dynamic OLS panel regressions with fixed effects of the net foreign asset to trade ratio (or NFA to GDP in col. 2, or NFA adjusted for the net present value of external debt in col. 3) on public debt to trade ratio, fertility, log of relative productivity, quality of institutions (constraint on executive), financial liberalization, and capital account liberalization. Additional controls encompass alternative measures of debt, demographics, capital account liberalization, relative income or productivity, terms of trade, trade restrictions, and agricultural price reforms. Unbalanced panel with annual data 1980–2006. Robust p-values are in parentheses.

[a]Indicates that the variable is constructed relative to the weighted average of the trading partners.

*$p < .1$.
**$p < .05$.
***$p < .01$.

Table 11
Net Foreign Asset Regressions with Different Slopes for Low-Income Countries and
High-Income Countries: Panel Dynamic OLS with Fixed Effects (Only Long-Run
Coefficients Reported)

| Variable | NFA to Trade | | Test of Equality of Coefficients (p-Values) |
	LICs	HICs and Emerging Markets	
Public debt to trade	−.4566***	−.0059	.000
	(.0000)	(.9141)	
Fertility[a]	−.3135***	−.2623**	.731
	(.0026)	(.0136)	
Relative productivity (log)[a]	1.5867***	.3129	.030
	(.0015)	(.3092)	
Constraints on executive	.2280***	.1221***	.074
	(.0000)	(.0007)	
Domestic financial liberalization[a]	2.0003***	.8670***	.059
	(.0001)	(.0088)	
Capital account liberalization[a]	−1.4137***	1.2703***	.000
	(.0010)	(.0000)	
Observations		1,414	
R^2		.87	

Note: Robust dynamic OLS panel regressions with fixed effects of the net foreign asset to
trade ratio on same fundamentals as in the benchmark (col. 1) of previous table, inter-
acted with dummy variables for our sample of low-income countries and a dummy vari-
able for richer countries, including advanced countries and emerging markets.
Unbalanced panel with annual data 1980–2006. Robust p-values are in parentheses.
[a]Indicates that the variable is constructed relative to the weighted average of the trading
partners.
*$p < .1$.
**$p < .05$.
***$p < .01$.

and institutions seems to follow the same economic pattern for both
sets of countries, although the size may be somewhat different.

4.   Speed of Adjustment

As in the real exchange rate analysis, we implement an error correction
specification in order to gauge the speed of adjustment of the net for-
eign asset position. An error correction term was derived via the differ-
ence of the net foreign assets from the sum of the products of the
fundamentals entering the baseline regression in table 10, column 1,
times the corresponding level coefficients. Error correction regressions
equivalent to the specification discussed above deliver robust OLS coef-
ficients of the lagged error correction term of around 0.25, suggesting
that shocks to the gap between the net foreign asset and its long-run
relationship have a half-life of about $2\frac{1}{2}$ years.

IV. Conclusions

This paper offers estimates of the relationship between the real effective exchange rate, the current account, and the net external asset position of low-income countries with respect to a set of fundamentals in the medium to long term. We find that the same broad set of economic fundamentals explain coherently the three indicators. The focus on low-income countries is motivated by the limited attention in the literature toward this set of countries and relies on factors that more closely characterize these countries, such as policies and distortions in the financial sector, the access to official external financing, and a higher sensitivity to exogenous shocks. The lack of attention paid to these countries has often been justified by data limitations, which led us to build a large database, unique in terms of the set of indicators and of countries that are covered.

We find that medium-term determinants of low-income countries' external balance are somewhat different from standard determinants found in the literature. In addition to standard determinants, aid flows (grants and concessional loans), domestic financial liberalization, the removal of capital account controls, the quality of institutions, shocks (terms of trade, natural disasters), and demographic measures have a significant impact on the indicators of external balance of low-income countries. The results are generally coherent across methodologies and—for standard economic indicators—are mainly in line with the existing literature.

Regarding policy distortions, domestic financial reforms are associated with an improvement of the current account and of the net foreign assets, suggesting a larger positive effect on saving than on investment. Capital account liberalization allows countries to borrow against disasters (lower current account) and allows lower-income countries in general to borrow from higher-income countries. Consistent with this result, capital account liberalization is associated with a more appreciated real exchange rate, in the long run, possibly because of the effect of capital inflows on absorption. Moreover, the quality of institutions is generally positively associated with larger external wealth in the long run.

Regarding shocks, a positive terms of trade shock tends to improve the current account and appreciate the real exchange rate, but mainly if it arises from a change in the export price (which is consistent with the fact that import prices are associated with an additional substitution effect working in the opposite direction than the income effect common to both the export and import prices). Natural disasters tend to be associated

with an improvement of the current account, unless the country has an open capital account. Moreover, some preliminary evidence suggests that the effect of income shocks on the current account may depend on the initial net foreign asset position.

Regarding external financing, an increase in aid arising from concessional loans or grants progressively results in higher imports, but the evidence suggests that part of aid flows are saved in the short run. In the long run, an increase in aid is associated with a depreciation of the real effective exchange rate. The latter result may be surprising in light of the standard Dutch disease argument but is consistent with more general theories of Dutch disease with learning by doing in both tradable and nontradable sectors (Torvik 2001). While aid may cause an appreciation of the real exchange rate in the short run (as expenditure on nontradables increases relative to supply), it may also be associated with a long-run depreciation if it is channeled to improve the productivity of nontradables relative to the productivity of tradables.

While we hope to have provided a coherent and comprehensive analysis of the current account, the real exchange rate, and the net foreign asset position in low-income countries, there is certainly scope for further research. A first priority is to improve the quality and the extent of data coverage. Several key indicators (not only black market premium but also the structural and financing indicators) are generally missing for numerous countries, an issue that would impair a proper economic assessment of their external balance. A deeper understanding of the nonlinearities underlying the relationship under investigation is certainly important. For example, analysis of the interaction between capital account liberalization and income, and between these two factors and other determinants, lags behind the wealth of theoretical hypotheses that have been put forward.

Appendix

The Database

The database includes data since 1980 for all countries with a population larger than 1 million people (see table A1). A few countries are dropped given substantial lack of data or very poor data quality. The database includes 134 countries, of which 31 are high-income countries, 26 are upper-middle-income countries, 36 are lower-middle-income countries, and 41 are low-income countries (based on the World Bank classification). Our low-income sample comprises the last two groups and excludes

Table A1
Low-Income County Sample

1	Albania[ac]	31	Macedonia, FYR
2	Algeria[c]	32	Madagascar[bac]
3	Azerbaijan, Republic of[bac]	33	Malawi
4	Bangladesh[bac]	34	Mali
5	Belarus[bc]	35	Morocco[bac]
6	Benin	36	Mozambique[bac]
7	Bolivia[bac]	37	Namibia
8	Burkina Faso[bac]	38	Nepal[c]
9	Cambodia	39	Nicaragua[ba]
10	Cameroon[bac]	40	Niger
11	Chad	41	Nigeria[bac]
12	Congo, Democratic Republic of	42	Papua New Guinea
13	Congo, Republic of	43	Paraguay[ac]
14	Côte d'Ivoire[bac]	44	Peru[bac]
15	Dominican Republic[bac]	45	Philippines[bac]
16	Ecuador[bac]	46	Rwanda
17	Egypt[c]	47	Senegal[ac]
18	El Salvador[bac]	48	Sierra Leone[b]
19	Ethiopia[bac]	49	Sri Lanka[bac]
20	Gambia, the[b]	50	Swaziland
21	Georgia[c]	51	Syrian Arab Republic
22	Ghana[bc]	52	Tanzania[bac]
23	Guatemala[bac]	53	Togo
24	Guinea	54	Tunisia[bac]
25	Honduras[b]	55	Uganda[bac]
26	Jamaica[bac]	56	Ukraine[bc]
27	Jordan[bac]	57	Uzbekistan[a]
28	Kenya[bac]	58	Vietnam[c]
29	Kyrgyz Republic[bc]	59	Zambia[b]
30	Lao People's Democratic Republic		

[a]Countries included in current account baseline (table 1, col. 9).
[b]Countries included in the real exchange rate baseline (table 5, col. 3).
[c]Countries included in the net foreign assets baseline (table 10, col. 1).

emerging markets to make the sample as homogeneous as possible (China, Colombia, India, Indonesia, Pakistan, and Thailand). Our high-income sample—mainly used as a comparator group—includes the first two groups and the six countries listed above. The regression sample is often smaller because of the unbalanced nature of the data set. In table A2 note "a" indicates that a variable is constructed relative to trading partners: the weights used are those employed by the INS system of the IMF to calculate real effective exchange rates (see below). Table A3 presents real deposit interest rates in selected Asian developing countries and the United States. Acronyms corresponding to the databases are listed at the end of this appendix.

Table A2
Descriptive Statistics

Variable	Mean	Standard Deviation	Minimum	Maximum
Current account to GDP	−.0544	.0785	−.4721	.2478
Fiscal balance to GDP[a]	−.0123	.0552	−.4710	.3733
Old-age dependency[a]	−.0946	.0304	−.1790	.0362
Population growth[a]	.0122	.0099	−.0268	.0528
NFA to GDP	−.7162	.7291	−10.1421	.4170
Oil balance to GDP	−.0063	.0915	−.3002	.6143
Relative income per capita	.0682	.0513	.0076	.2671
GDP per capita growth[a]	−.0104	.0509	−.3038	.2800
Aid to GDP	.0874	.0984	−.0369	.8246
Concessional loans	.0265	.0357	−.0889	.4347
Net grants	.0623	.0733	.0008	.7781
Terms of trade (goods and services)	4.6358	.2763	3.7473	5.9550
Capital account liberalization (other)	.4414	.3366	.0000	1.0000
Capital account liberalization	.5082	.2777	.0000	1.0000
Log of REER (INS)	4.6565	.3428	2.6794	5.8910
Log of REER (PWT)	−.7972	.4644	−2.2663	1.5944
NFA (with NPV debt) to trade	−2.5941	3.5943	−24.5817	1.0167
Government consumption to GDP[a]	−.0378	.0568	−.1454	.3731
Terms of trade goods (log)	4.6677	.3125	3.2149	6.1624
Fertility[a]	2.7400	1.3487	−.5279	4.8621
GDP per worker PWT (log)	8.4248	.8345	6.6902	10.0493
Trade restrictions[a]	.1729	.1858	−.2463	.8064
Administered prices[a]	.0223	.3242	−.3087	.9738
Max price intervention[a]	.1833	.4988	−.5313	.9372
Natural disaster	.5195	.4998	.0000	1.0000
Violent political transition	.0680	.2518	.0000	1.0000
Public debt to trade	3.2464	3.3911	.0080	28.7196
Relative productivity (log)[a]	−1.9131	.6679	−3.5656	.0631
Domestic financial liberalization[a]	−.2942	.1710	−.6908	.1458
Constraint on executive	3.6352	1.9312	1.0000	7.0000
NPV of external debt to trade	2.2657	2.4506	.0323	21.4463

[a]Indicates deviation from trading partners.

Exchange Rates

The real effective exchange rate

• The natural logarithm of the CPI-based real effective exchange rate from the IMF (INS).

• The database also includes a measure of the real exchange rate computed based on the PWT variable "P," which captures price levels relative to the United States. The natural logarithm of this variable is taken, and it is then computed in deviations from trading partners, using the same weights as the INS one.

Table A3
Real Deposit Interest Rates in Selected Asian Developing Countries
and in the United States

	1968–74	1975–81	1982–88
Bangladesh	−7.88	−3.19	2.33
India	−2.46	.07	1.13
Indonesia	−1.21	−5.8	7.57
Korea	1.58	−2.58	5.13
Malaysia	2.01	1.79	5.37
Nepal	−.62	4.04	3.36
Pakistan	−2.33	−1.55	2.96
Philippines	−4.22	−.16	−.32
Sri Lanka	−4.52	.27	4.08
Taiwan	.34	2.88	5.48
Thailand	1.24	1.52	7.67
United States	1.31	.24	4.86

Source: Fry (1995) and authors' calculations for the United States (annual average continuously compounded rates). Data for the United States are from the International Financial Statistics (lines 60lc and 64).

Black market premium

• The black market premium (BMP) is computed as the log difference between the black market nominal exchange rate and the official nominal exchange rate, both in local currency per U.S. dollar. The data are annual averages of the monthly data from Reinhart and Rogoff (2004).

Demographics

Fertility

• Total fertility from United Nations population data (2006) is defined as the average number of children a hypothetical cohort of women would have at the end of their reproductive period if they were subject during their whole lives to the fertility rates of a given period and if they were not subject to mortality. It is expressed as children per woman.

Infant mortality ratio

• Infant mortality rate from United Nations population data (2006) is defined as infant deaths per 1,000 live births.

Old-age dependency ratio

• The old-age dependency ratio captures the share of people older than 64, relative to the working-age population, defined as in the age group 15–64. The data are based on UN data, annualized by the World Bank. The variable is computed in deviations from trading partners.

Population growth

• The population growth data are computed from World Bank data, extended with UN projections.

External

Current account

• The current account to GDP ratio is based on WEO data.

Net foreign assets

• Net foreign assets, lagged 1 year, is computed relative to average trade for the real exchange rate regressions approach and relative to GDP for the current account regression (net foreign asset regressions encompass various versions of this indicator, as discussed in the text). Data on net foreign assets in nominal terms are provided by Gian Maria Milesi-Ferretti. Trade data are from WEO or from IFS spliced with WEO data.

• Data on net foreign assets in net present value (NPV) terms are computed by adding back into net foreign assets the measure of total debt and then subtracting time-series data on the present value of debt from the World Bank. As the World Bank measure on the present value of debt is based only on long-term public and publicly guaranteed debt as well as use of IMF credit, we additionally subtracted short-term and long-term private nonguaranteed debt (which is not likely to be subject to a substantial element of concessionality). For the few countries without data for the present value of debt, the nominal values are used.

• For a few countries, the cumulative current account is used in place of net foreign assets since the latter was unavailable.

Aid

• Foreign aid relative to GDP. The measure of foreign aid is computed by Roodman (2006). It is based on Official Development Assistance–Development Assistance Committee data and is computed as total net aid minus debt forgiveness plus offsetting entries for debt relief. The data are in millions of U.S. dollars and are computed relative to WEO nominal GDP in millions of U.S. dollars. We include in our estimations the concessional loans and net grants. The loans are constructed as foreign aid minus the net grants, and the latter is constructed as total grants minus debt forgiveness grants.

Oil balance

• The oil balance to GDP ratio is from WEO.

Fiscal

Fiscal balance

• The general government balance relative to GDP, using the central government balance for some countries where the general balance is not available. The data are from WEO.

Government consumption

• Government consumption relative to GDP is from the OECD, spliced with data from IFS and WEO.

Income-Related Variables

GDP per capita growth

• Growth rate of GDP per capita from WEO.

Relative productivity

• The baseline measure of productivity is measured as real PPP GDP per capita from the Penn World Table, extended with World Bank WDI Data.

GDP per worker PWT

• Real GDP divided by the number of worker, from the Penn World Table.

Relative income per capita

• Relative income per capita is PPP income per capita, relative to the United States. The data are from the World Bank.

Income groups

• Income groups are aggregated on the basis of the World Bank income group classifications.

Shocks

Natural disasters

• Natural disaster data from the International Disaster Database (EM-DAT), Centre for Research on the Epidemiology of Disasters (CRED), include binary dummy variables (1 for event, 0 for no event) for droughts, earthquakes, extreme temperatures, floods, volcanoes, wave surges, wildfires, and windstorms. It is the average of these indicators.

Wars

• War dummies from PRIO/Uppsala Armed Conflict Dataset, Version 4-2006 (Gleditsch et al. 2002) are based on four types of conflicts: (i) extra systemic armed conflict (between a state and a nonstate group outside its own territory); these conflicts are by definition territorial, since the government side is fighting to retain control of a territory outside the state system; (ii) interstate armed conflict (between two or more states); (iii) internal armed conflict (between the government of a state and one or more internal opposition group[s]); and (iv) internationalized internal armed conflict (between the government of a state and one or more internal opposition group[s] with intervention from other states on one or both sides). Each type of conflict is coded as 0, no conflict; 1, minor; 2, intermediate; and 4, war (at least 1,000 deaths per year).

Goods terms of trade

• The natural logarithm of terms of trade of goods (WEO).

Goods and services terms of trade

• The natural logarithm of terms of trade of goods and services (WEO).

Commodity-based terms of trade

• We also use for robustness the ratio of a weighted average price of the main commodity exports to a weighted average price of the main commodity imports. The index for six commodity goods is constructed as in Ricci et al. (2008). The index for 32 commodities encompasses aluminum, bananas, beef, cocoa, coconut oil, coffee, copper, corn, cotton, crude oil, fish meal, gold, hard log, hides, iron, lamb, lead, nickel, palm oil, rice, rubber, shrimp, soybean meal, soybean oil, soybeans, sugar, sunflower oil, tea, tin, wheat, wool, and zinc.

Capital account liberalization

• The capital account liberalization measure from the IMF Research Department's structural reform database is an index, normalized between 0 and 1. It is computed by Dennis Quinn and measures restrictions on capital account transactions.

• An alternative measure of capital account liberalization is taken from Abiad, Detragiache, and Tressel (2008).

Domestic financial reforms

• The domestic financial reform measure is an index, coded between 0 and 1. It is from the IMF Research Department's structural reform database.

Price controls

• Administered agricultural prices is a [0, 1] dummy reflecting the strong presence of price controls in the agricultural sector (from the agricultural product market index of the IMF Research Department's structural reform database; code = 3).

• Max agricultural price intervention is a [0, 1] dummy reflecting the presence of marketing boards setting the prices (from the agricultural product market index of the IMF Research Department's structural reform database; code = 4).

• Administered prices is a measure of price controls based on the share of administered prices in the CPI from the EBRD, available for transition economies only (see Ricci et al. 2008).

Trade restrictions

• Data on trade restrictions are from the IMF Research Department's Structural Reform Database. It is based on data for average tariffs and is normalized between 0 and 1 on the basis of smallest and largest observation in the sample.

• An alternative measure of trade restrictions is from Wacziarg and Welch (2003), who extended the liberalization years suggested by Sachs and Warner (1995).

Institutions

Constraints on executive

• Polity IV constraint on the executive variable (xconst), censored at zero for negative values.

Violent political transition

• Dummy variable equal to one whenever constraint on executive is negative and equal to zero otherwise.

Other Controls

Change in private credit to GDP

Source: World Bank.

Notation

EBRD: European Bank for Reconstruction and Development
IFS: International Monetary Fund's International Financial Statistics

INS: International Monetary Fund's Information Notice System
PWT: Penn World Table
UN: United Nations
WB: World Bank
WEO: International Monetary Fund's World Economic Outlook

Endnotes

1. This literature has been drawing from an earlier literature on the determinants of saving in advanced countries and emerging markets (Schmidt-Hebbel, Webb, and Corsetti 1992; Edwards 1995; Masson, Bayoumi, and Samiei 1998) and of capital flows (e.g., Bosworth and Collins 1999).

2. For a recent application to central and eastern European countries, see Maeso-Fernandez, Osbat, and Schnatz (2004).

3. For recent contributions, see Chudik and Mongardini (2007), Di Bella, Lewis, and Martin (2007), Elbadawi (2007), Roudet, Saxegaard, and Tsangarides (2007), Delechat (2008), and Kireyev (2008). The impact of fiscal and monetary policies on the real exchange rate and the current account in the presence of large distortions has been explored by Edwards (1988) and Prati and Tressel (2006). Prati and Tressel (2006) and Berg et al. (2007) show in particular that aid recipient countries' absorption of foreign aid inflows is affected by policy responses, often resulting in the accumulation of foreign exchange reserves.

4. Gourinchas and Jeanne (2009) argue that the patterns of capital flows to developing countries do not coincide with the predictions of the standard neoclassical theory and suggest a theory based on frictions affecting saving and investment decisions. Many low-income countries initiated capital account liberalization during the period of analysis, which gives us the possibility to test these and other theoretical predictions.

5. For a theoretical and empirical extension of the real exchange rate analysis to a setup with imperfect substitutability, see MacDonald and Ricci (2007).

6. Blanchard (1985) and Weil (1989) present models breaking Ricardian equivalence in infinitely lived agent models by introducing, respectively, a positive probability of death and successive cohorts of infinitely lived agents. In such models, a fiscal deficit (surplus) raises (reduces) the current generation's consumption and reduces (increases) the current account balance by shifting taxes to future (unborn) generations.

7. However, with country fixed effects, the fiscal balance tends to become insignificant in a sample of advanced countries (Chinn and Prasad 2003; Chinn and Ito 2007; Gruber and Kamin 2007).

8. In a growing economy, a positive steady-state relationship between the current account and the net foreign assets would also be observed. Blanchard (1985) and Weil (1989) present models with uncertain horizon or distinct infinitely lived dynasties, where the

current account does not need to be zero in the steady state even with infinitely lived agents: countries with positive (negative) steady-state net foreign assets will enjoy a current account surplus (deficit) in the steady state. There could also be systematic differences between debtor and creditor countries in the relationship between current account and net foreign assets (Kraay and Ventura 2000).

9. The effect of trend output growth on the current account can be ambiguous. In an overlapping generations model, an increase in trend output growth also raises aggregate savings by raising the wealth accumulated by the young relative to the wealth decumulated by the old (who had lower income when young). Hence such a model predicts a positive effect of trend output growth on the current account (Modigliani 1986).

10. The effect is more complex in the presence of nonhomogeneous goods (see MacDonald and Ricci 2007).

11. Greenwood and Jovanovic (1990) show that domestic financial reforms may increase investment by relaxing borrowing constraints. More broadly, the large literature has identified theoretically and empirically the channels through which financial development affects investment and economic growth (e.g., Fry 1995; Levine 1997).

12. Empirical contributions found a weak link between domestic financial liberalization—measured by the real interest rate—and private saving rates in developing countries (Loayza, Schmidt-Hebbel, and Servén 2000).

13. An alternative model of the effect of financial globalization on the external position is the one of Martin and Rey (2006), who show that financial liberalization can result in a crash and a reversal of the current account. To account for such effects, our empirical estimations will include dummy variables for financial crisis.

14. Empirical evidence has not confirmed the direction of capital flows predicted by the basic neoclassical theory. See, e.g., Prasad, Rajan, and Subramanian (2007) and Gourinchas and Jeanne (2009).

15. Permanent liberalization may also affect the current account if perceived as temporary: if the reforms lack credibility and agents anticipate a policy reversal, agents will consume more today, and the current account would deteriorate because of intertemporal substitution effects (Calvo 1987).

16. Liberalization would also increase permanent income if the distortion associated with trade restrictions reduces productivity (e.g., because of lower availability of intermediate inputs used in a love-for-variety production function, such as a Dixit-Stiglitz one).

17. It may also depend on the initial net foreign asset position (Kraay and Ventura 2000; Guo and Jin 2009).

18. Torvik (2001) shows how such ambiguity results from a model with traded and nontraded sectors, learning by doing, and spillover effects. If aid tends to expand the size of the nontraded sector, productivity will grow faster in the nontraded sector than in the traded sector, as a result of stronger learning by doing in the nontraded sector. Hence, the real exchange rate will depreciate in the long run as a result of a permanent aid inflow.

19. See Prati and Tressel (2006) and Berg et al. (2007) for evidence on the relationship between aid flows, policies, and current account balances in aid-receiving countries and Mongardini and Rayner (2009) for evidence on the relationship between aid flows, policies, and the real exchange rate.

20. Extensive borrowing on concessional terms implies that net present value calculations are crucial in order to derive realistic indicators of the net external position of low-income countries. New measures of net foreign assets encompassing the net present value of external debt have been constructed, which for some countries can be substantially different from the standard net foreign asset measure.

21. We are grateful to Ibrahim Levent and his team at the World Bank for sharing with us the net present value calculations.

22. Most variables in the analysis are computed in relation to trading partners, and the main results are not affected if we also remove the period sample mean from other variables.

23. We use the aggregate measure of foreign aid adjusted for debt relief, in percent of GDP, as constructed by Roodman (2006).

24. The estimated effects of aid flows on the current account are generally robust to small changes in the regression sample. However, the estimated coefficient of grants reported in

the specification of col. 2 becomes closer to the one of cols. 6, 8, and 9 when run on the same sample.

25. Our findings are also consistent with the model of Gourinchas and Jeanne (2009), who suggest that saving wedges may be more important than investment wedges in developing countries. However, they are less consistent with Caballero et al. (2008) and with Mendoza et al. (2009), who show how the lack of financial development may result in precautionary savings and therefore higher current account balances.

26. Real deposit rates increased between the early 1970s and the end of the 1980s in a sample of Asian countries that moved from financial repression to financial liberalization over this period (Fry 1995).

27. Whether private agents partly save these windfall earnings is a subject for future research. Our aggregate estimates suggest that part of aid is saved over a 4-year horizon, which may be caused by macroeconomic policy responses or by private agents' consumption-saving decisions.

28. The measure is defined as the frequency of negative income shocks over a 4-year period, where natural disasters include floods, droughts, earthquakes, and windstorms. Such natural events are typical, frequent, and likely to have macroeconomic implications in low-income countries. Such exogenous negative income shocks are very frequent in our sample (frequency of 0.6 over the sample period).

29. In a country with a fully liberalized capital account, a natural disaster occurring at average frequency of 0.6 during a 4-year period would be associated with a GDP deterioration of the current account of −0.7%.

30. Guo and Jin (2009) show that a portfolio composition effect might dominate the income effect in past data.

31. There was, however, a large dispersion of real deposit rates in developing countries over the period 1970–90 (Gelb 1991).

32. Controlling for lags of grant and concessional loans also does not affect our main results (regression available on request).

33. However, if we omit the country fixed effects to test for long-run cross-country differences, we tend to find the opposite sign on this interaction term: countries that experience faster economic growth tend to run lower current account balances when they liberalize their capital account (on the contrary, Gourinchas and Jeanne [2009] find evidence that countries with faster productivity growth tend to attract *less* foreign capital).

34. The total effect of capital account openness on the current account turns positive at a GDP per capita of about two-thirds the U.S. GDP per capita for countries that do not experience natural disasters and of one-third that of the United States for countries that experience natural disasters.

35. Panel unit root tests are based on Pesaran (2007) to control for cross-sectional dependence. We are very grateful to Peter Pedroni for running the panel unit root tests using his RATS programs. Panel cointegration tests are based on the group mean augmented Dickey-Fuller panel cointegration test (Pedroni 1999, 2004).

36. The benchmark regressions are virtually unchanged if we include time dummies (available on request) to account for possible common movements in the real effective exchange rate of low-income countries associated, e.g., with an exchange adjustment in the currencies of advanced economies.

37. An alternative explanation for the negative coefficient is the presence of endogeneity. In particular, countries that are experiencing depreciating exchange rates while in economic difficulties may also be aid receivers. However, such an interpretation would not be consistent with the long-run nature of the estimated cointegration relationship. Moreover, when we replace the aid measure with the ratio of aggregate aid to aggregate GDP in low-income countries (which is positively related to countries' aid ratios but is not related to country-specific exchange rate fluctuations), the coefficient remains negative and significant. We also checked the short-run effect of aid, via the coefficients of changes in the aid measure in an error correction specification (which will be discussed below), but these are insignificant when either one, two, three, or four lags of the changes are entered.

38. We prefer the ratio of net foreign assets to trade to the one to GDP since the latter is more sensitive to fluctuations in the exchange rate, which we know is correlated with the right-hand-side variables. The public debt data are from Jaimovich and Panizza (2006); as the availability of public debt data for low-income countries is limited, the variable is

spliced with external debt (mostly public in low-income countries) for a few countries. Time dummies might be appropriate to absorb common movements in the net foreign asset position of low-income countries arising from, e.g., exchange rate fluctuations that may cause valuations effects; results are virtually identical (available on request). The net foreign asset regressions drop Nicaragua from the sample because of extreme values of both debt and net foreign assets, which would increase the coefficient of debt substantially (almost to one, i.e., double).

39. An alternative explanation is related to the high correlation of these indicators with the level of development, which may affect savings as discussed above and may be only imperfectly captured by income per capita.

40. This result could be due to deficits being more monetized in low-income countries than in high-income ones: deficits financed by money creation would be less likely to result in external debt, whereas deficits financed by public debt would be more likely to result in external debt. Hence, the lower effect of the fiscal balance on the current account may simply reflect the average of two effects, whereas the one of debt on net foreign assets would capture only one of them.

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