Exchange Rate Risk, Contract Enforcement, and Trade — A Theoretical Investigation

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Abstract

It is commonly claimed that exchange rate risk depresses international trade. However, both theoretical and empirical contributions to the literature fail to offer conclusive support to this assertion. This paper reconciles the seemingly contradictory findings by pointing out the key interaction between the impact of exchange rate risk on trade and institutional quality, an aspect that has surprisingly been neglected so far. The trade effects of exchange rate risk are reconsidered in a setting with risk-neutral agents and imperfect contract enforcement. The level of enforcement is modelled as an exogenous probability that a defaulter is forced to execute his contract and can be thought of as a measure of institutional quality. An important implication of the analysis is the non-monotonicity of the association between the trade effects of exchange rate risk and level of contract enforcement. In particular, a clear distinction can be made among three cases. First, an increase in exchange rate risk dramatically inhibits trade when the institutional support for contract enforcement is sufficiently poor. Second, an increase in exchange rate risk encourages trade for some intermediate levels of contract enforcement. Third, for sufficiently high levels of contract enforcement the impact of exchange rate risk on trade is negligible.

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