

# TRADE, PRODUCTION NETWORKS AND THE EXCHANGE RATE

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## ABSTRACT

This paper examines the effect of cross-border production sharing on the sensitivity of trade to the exchange rate and to other key variables. Theoretically, the response of a country's exports to the exchange rate should decline as the share of exported components for use in the manufacture of its imports rises. Similarly, the response of its imports of end products should decline as the share of its exported components in those imports rises. The response of a country's imports to domestic GDP should decline and the response to the exporting country's GDP should rise as the share of imported components for use in the manufacture of exports rises. These propositions are tested for trade between the U.S. and Mexico, using OLS and VEC techniques and allowing for the impact of NAFTA. The findings broadly confirm the aforementioned priors. In addition to their implications for trade-balance adjustment, these results have potentially important implications for the choice of exchange-rate regime.

JEL Codes: F14, F15, F32

Keywords: trade balance; fragmentation; intra-industry trade; exchange rates; NAFTA.

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