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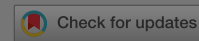
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Original Articles

Developmental states and undervalued exchange rates in the developing world

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ABSTRACT

This paper investigates why some developing countries maintain weak and undervalued exchange rates while others do not. I argue that one key feature of the 'developmental state' – namely, state control over the financial system – contributes to an undervalued exchange rate. However, state control of finance promotes undervaluation under a narrower set of conditions than most developmental state theories

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suggest that state institutions influence exchange rate policy, though their effects are contingent upon the configuration of interests in society.

KEYWORDS: [exchange rates](#) [currency policy](#) [export-led growth](#) [state-owned banks](#) [developmental state](#) [interest groups](#)

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Disclosure statement

No potential conflict of interest was reported by the author.

Supplemental data

Replication data and a supplementary appendix are available on the author's website, <https://www.sais-jhu.edu/dstein23>.

Notes

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but analyze both the exchange rate level and the exchange rate regime. The third

study (Iversen and Soskice [2010](#)) focuses on a different group of countries from the present paper: advanced industrialized nations, rather than developing ones. Steinberg's ([2015](#)) book contains cross-national statistical analyses of the political determinants of exchange rate levels in developing countries.

2. By comparison, it seems less likely that a meritocratic bureaucracy, another commonly cited attribute of a developmental state, would influence exchange rate policy.
3. By contrast, the short-run effects of undervaluation may not be positive. Devaluations often reduce output within their first year (Gupta et al. [2007](#)).
4. Rodrik ([2008](#)) argues in favor of undervaluation on the grounds that it helps correct for market failures. For an example of the orthodox position, see Williamson ([1990](#)), which lists a 'competitive exchange rate' – defined as a non-overvalued exchange rate – as one of the ten elements of The Washington Consensus. According to Williamson ([2009](#): 9), 'overvalued exchange rates are worse than undervalued rates, but a rate that is neither overvalued nor undervalued is better still.'
5. There are many examples of high-level policymakers that have recognized the benefits of maintaining an undervalued exchange rate. For example, former Nigerian Finance Minister, Kalu Idika Kalu, 'question[ed] the merits of having a strong currency' (Fuady, [2013](#): 162). Many top officials in Indonesia's government during the 1970s and 1980s recognized the wisdom of maintaining a relatively weak exchange rate (Fuady, [2013](#): 166–169). One year prior to becoming Argentina's Finance Minister, Domingo Cavallo published an article showing that overvalued exchange rates reduce economic growth (Cottani, Cavallo, and Khan, [1990](#)).
6. For strong evidence that individuals tend to discount the future benefits of policies, see Jacobson et al. ([2014](#)).
7. Agricultural growth in developing countries is often driven by agricultural growth in the agricultural sector (see [2008](#)).
8. For a discussion of the role of agricultural growth in the agricultural sector, see [2014](#).

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9. In the World Bank Enterprise Survey (2002–2006), the average manufacturing firm imports 32% of all its inputs into production ($n = 44,999$), finances 20% of its investments from local bank borrowing ($n = 26,839$), and 15% of its debts are denominated in foreign currency ($n = 18,263$).
10. Students and workers were the main constituencies of Ghana's government at the time. They supported overvaluation (Herbst, [1993](#): 41–43).
11. There is one difference between my measure and Rodrik's: Rodrik constructs a measure of undervaluation; I invert his scale to create a measure of overvaluation.
12. Augmented Dickey-Fuller tests indicate that overvaluation is not likely to suffer from unit root problems. The null hypothesis that all panels have a unit root was overwhelmingly rejected ($p < 0.001$). To provide more conservative tests, I also ran separate tests for each developing region (Eastern Europe & Central Asia, Latin America, Middle East & North Africa, Sub-Saharan Africa). For each of these sub-samples, the null hypothesis was rejected with $p < 0.05$.
13. I do not control for GDP per capita because its influence is already incorporated into the dependent variable. Further controlling for economic development with a variable measuring per capita energy consumption or a country's income grouping (as defined by the World Bank) has little impact on the main results.
14. Pooled and random-effects estimators also produce substantively similar results, as shown in the supplementary appendix.
15. The main results are similar when a lagged-dependent variable is used in place of the AR1 term (see online appendix). The latter is more appropriate because lagged-dependent variables absorb the time-series dynamics and prevent the regressors from explaining changes in the level of the dependent variable (Plümper et al., [2005](#)).

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regional dummies) in the equation used to estimate the equilibrium real exchange rate.

19. These variables are taken from Ilzetzki et al. ([2008](#)).

20. I use Frankel and Rose's ([1996](#)) widely used definition of a currency crisis, which is a nominal exchange rate depreciation greater than 25% that is also a 10% or larger increase in the rate of depreciation. Using the percentage change in the nominal exchange rate instead produces similar results (see the appendix).

21. La Porta et al.'s ([2002](#)) data are not suitable for panel analyses because they are only available for two years, 1975 and 1995.

22. When using Micco et al.'s ([2007](#)) variable, the estimates are not statistically significant, though their magnitude is similar to the other models.

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