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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

1. Rec ... es Bearce (200 ... er (2010). I am only ... f the exchang ... vitch and Pevehou ... n this issue, 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 Jaco

7. Agricu sts render agricultu Broz et al., 2008 gricultural secto 981).

8. For a th (2014).

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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17. T ... ki et al. (2008) ...

18. Altho ... eaknesses, including ... bles (e.g., 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.