The Reallocation Effects of Real Exchange Rate Undervaluations

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Abstract

Recently, there has been renewed interest in the effect of industrial policy on industry performance. In this paper, we provide evidence that undervaluation of the real exchange rate has significantly increased labor productivity in skill intensive manufacturing sectors, while reducing it in labor intensive sectors in a large sample of developing countries in the period 1980-2004; the effect of the same policy on this outcome has been instead insignificant in industrialized countries. Simultaneously, undervaluation has increased employment and value added growth disproportionately more in labor-intensive sectors than in skill-intensive ones in all countries. We rationalize this finding in a multi-sector Melitz (2003) model, where sectors differ in their skill-intensity and tradability and show that undervaluation can reproduce the empirical facts purely through reallocation of resources between and within sectors, without requiring any learning-by-exporting or other externalities that might justify such a policy intervention.

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