

The Real Exchange Rate and Economic Growth: Theory and Evidence*

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Abstract

I provide evidence that undervaluation (a high real exchange rate) stimulates economic growth. This is true particularly for developing countries, suggesting that tradable goods suffer disproportionately from the distortions that keep poor countries from converging. I present two categories of explanations as to why this may be so, focusing on (a) institutional/contractual weaknesses, and (b) market failures. A formal model elucidates the linkages between the level of the real exchange rate and the rate of economic growth.

1 Introduction

Economists have long known that poorly managed exchange rates can be disastrous for economic growth. Avoiding overvaluation of the currency is one of the most robust imperatives that can be gleaned from the diverse experience with economic growth around the world, and it is one that appears to be strongly supported by cross-country statistical evidence (Razin and Collins 1997, Johnson, Ostry, and Subramanian 2007). The results in the well-known papers of Dollar (1992) and Sachs and Warner (1995) on the relationship between outward orientation and economic

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growth are largely based on indices that capture degrees of overvaluation (Rodriguez and Rodrik 2001). Much of this literature on cross-national policy regressions is now in disrepute (Easterly 2005; Rodrik 2005). But it is probably fair to say that the admonishment against overvaluation remains as strong as ever. In his pessimistic survey of the crossnational growth literature, Easterly (2005) agrees that large overvaluations have an adverse effect on growth (while remaining skeptical that moderate movements have determinate effects).

The reason behind this regularity is not always theorized explicitly, but most accounts link it to macroeconomic instability (e.g. Fischer 1993). Overvalued exchange rates are associated with shortages of foreign currency, rent-seeking and corruption, unsustainably large current account deficits, balance-of-payments crises, and stop-and-go macroeconomic cycles—all of which are damaging to economic growth.

I argue in this paper that this is not the whole story. Just as overvaluation hurts growth, undervaluation facilitates it. For most countries, high-growth periods are associated with undervalued currencies. In fact, there is little evidence of non-linearity in the relationship between a country's (real) exchange rate and its economic growth. An increase in undervaluation boosts economic growth just as well as a decrease in overvaluation. But this relationship holds only for developing countries; it disappears when we limit the sample to richer countries. These suggest that more than macroeconomic stability is at stake. The relative price of tradables to non-tradables (the real exchange rate) seems to play a more fundamental role in the growth process.¹

Here are a few pictures to make the point as directly as possible. Figures 1-7 depict the experience of seven countries during 1950-2004: China, India, South Korea, Taiwan, Uganda, Tanzania, and Mexico. In each case, I have graphed side-by-side my measure of real exchange rate undervaluation (to be defined more precisely below) against the country's economic growth rate in the corresponding period. Each point on the chart represents an average for a 5-year window.

To begin with the most fascinating (and globally significant) case, the degree to which economic growth in China tracks the movements in my index of undervaluation is uncanny. The rapid increase in economic growth starting in the second half or the 1970s is very closely tracked by the increase in the undervaluation index (from an *overvaluation* close to 100 percent to an undervaluation of around 50 percent), as

¹Among recent work Bhalla's (2007) forthcoming monograph stands out as the one with the most similar message to that in the present paper. Bhalla also emphasizes the growth promoting role of undervaluation, even though his empirical approach is different than the one employed here. I had completed the bulk of the work for this paper before I was alerted by Robert Lawrence to Bhalla's manuscript.

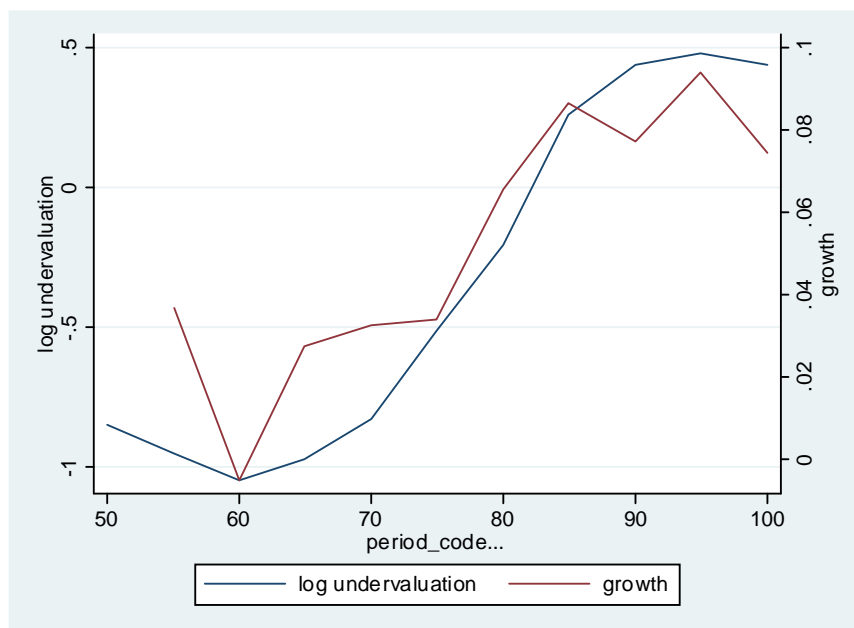


Figure 1: China: Undervaluation and economic growth

is the plateauing of the growth rate in the 1990s. Analysts who focus on global imbalances have of course noticed in recent years that the Renminbi is undervalued (given China’s large current account surplus). They have played less attention to the role that undervaluation seems to have played in driving the country’s economic growth.

Turn next to India (Figure 2), the other growth superstar of recent years. The figure is less clearcut than that for China, but its basic message is quite clear and the same. India’s economic growth has steadily climbed from slightly above 1 percent in the 1950s (in per-capita terms) to 4 percent by the early 2000’s, while its real exchange rate has moved from a small overvaluation to an undervaluation of around 60 percent. Figures 3 and 4 display the experience of two East Asian tigers—South Korea and Taiwan—which were growth champions of an earlier era. What is interesting in these instances is that the growth slowdowns in recent years are in each case accompanied by growing overvaluation or reduced undervaluation. In other words, both growth and undervaluation exhibit an inverse-U shape over time.

These regularities are hardly specific to Asian countries. Figures 5 and 6 depict two African experiences, those of Uganda and Tanzania. In each case, the under-

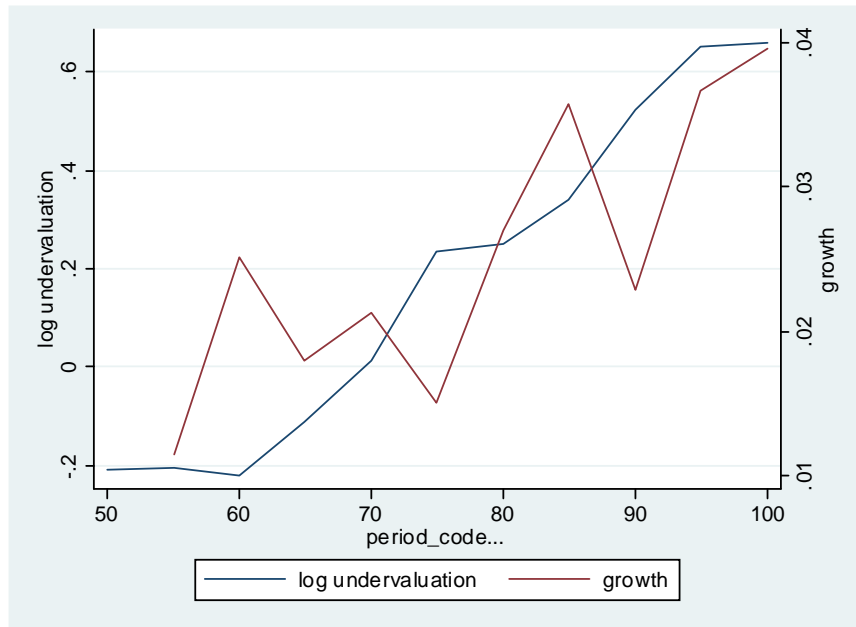


Figure 2: India: Undervaluation and economic growth

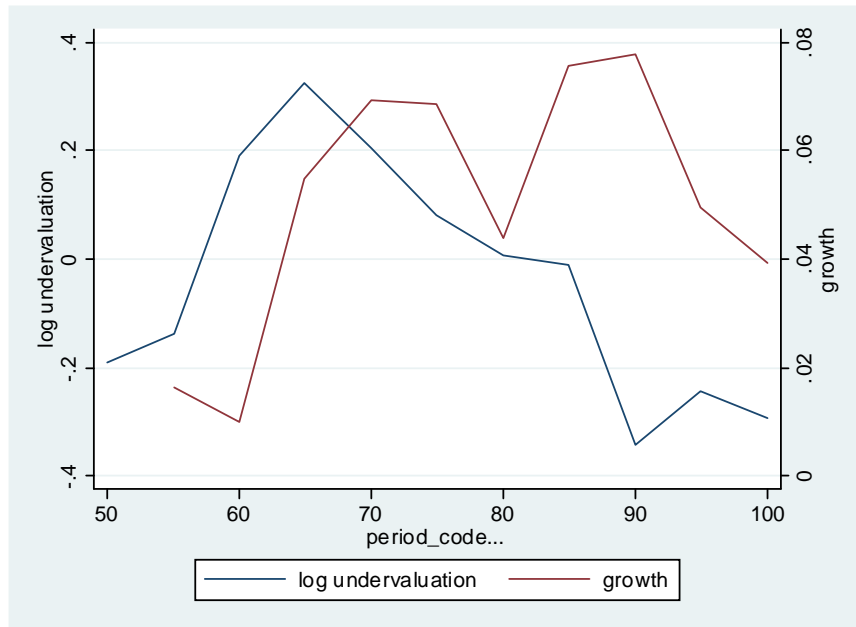


Figure 3: South Korea: Undervaluation and economic growth

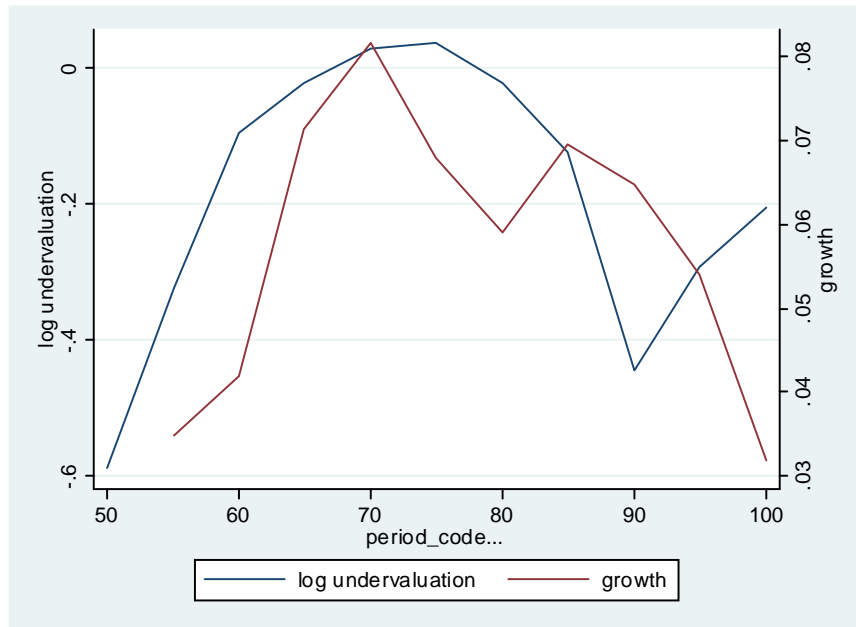


Figure 4: Taiwan: Undervaluation and economic growth

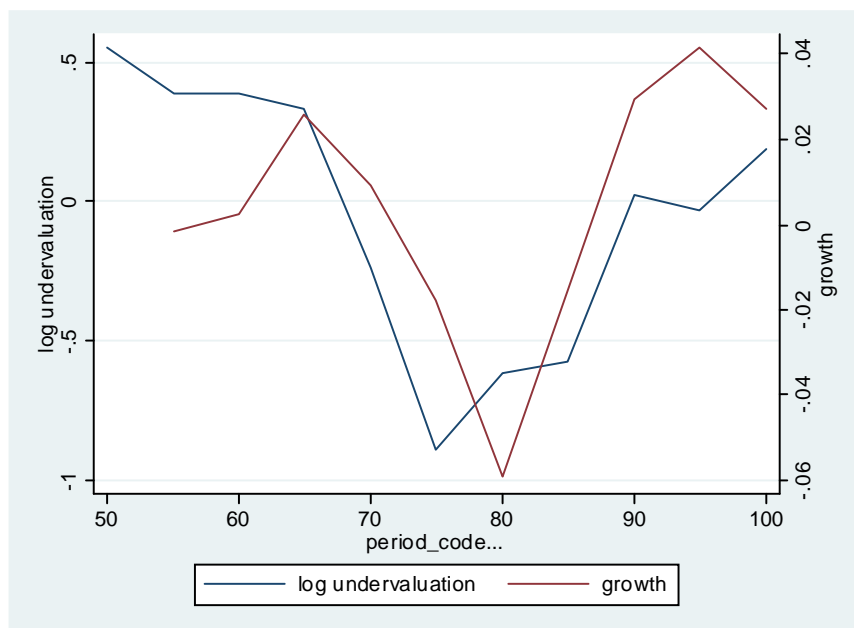


Figure 5: Uganda: Undervaluation and economic growth

valuation index captures the turning points in economic growth exceptionally well. Slowdown in growth is accompanied by increasing overvaluation, while a pickup in growth is accompanied by a rise in undervaluation. Finally, Figure 7 shows a somewhat anomalous Latin American case, Mexico. Here the two series seem quite a bit out of whack, especially since the 1980s when the correlation between growth and undervaluation turns negative rather than positive. Those familiar with the recent economic history of Mexico will recognize this to be a reflection of the capital-inflows induced growth cycles of the country. Periods of capital inflows are associated with consumption-led growth booms and currency appreciation; when the capital flows reverse, the economy tanks and the currency depreciates. The Mexican experience is a useful reminder that there is no reason a priori to expect a positive relationship between growth and undervaluation. It also suggests the need to go beyond individual cases and undertake a more systematic empirical analysis.

In the next section I do just that. First I construct a time-varying index of real exchange rate undervaluation, based on Penn World Tables data on price levels in individual countries. My index of undervaluation is essentially a real exchange rate adjusted for the Balassa-Samuelson effect. It captures the relative price of

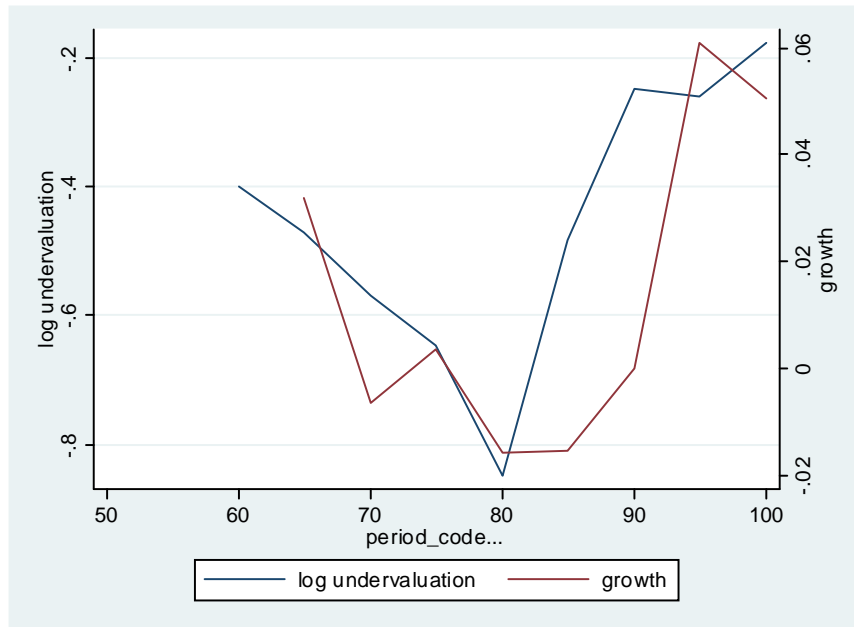


Figure 6: Tanzania: Undervaluation and economic growth

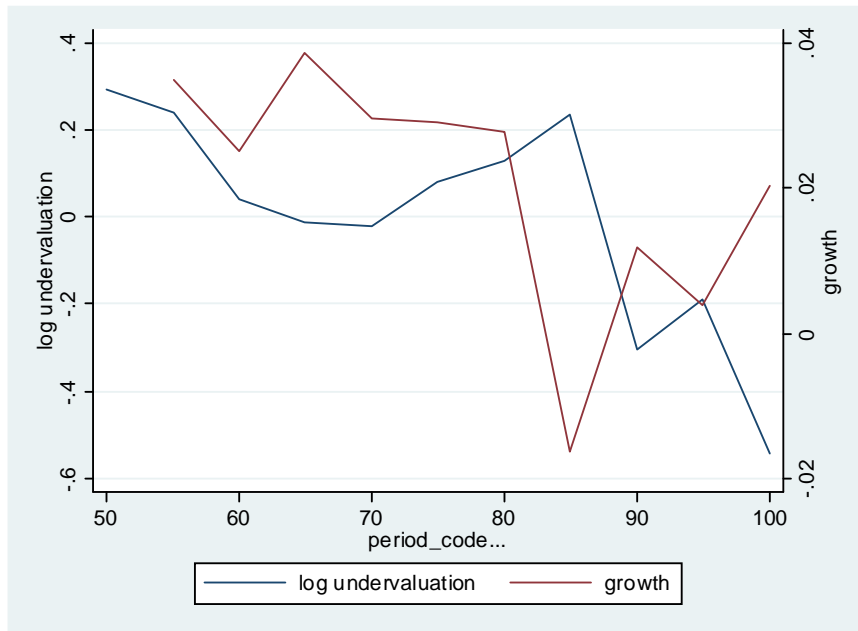


Figure 7: Mexico: Undervaluation and economic growth

tradables to non-tradables, adjusting for the fact that richer countries have higher relative prices of non-tradables (due to higher productivity in tradables). I next show in a variety of fixed-effects panel specifications that there is a systematic positive relationship between growth and undervaluation, especially in developing countries. So the Asian experience is not an anomaly. While ascertaining causality is always difficult, I argue that in this instance causality is likely to run from undervaluation to growth rather than the other way around.

Hence developing countries that find ways of increasing the relative profitability of their tradables are able to achieve higher growth. These results suggest strongly that there is something "special" about tradables at low- to middle-income levels. In the rest of the paper I examine the reasons behind this regularity. What is the precise mechanism through which an increase in the relative price of tradables increases growth? I present two classes of theories that would account for the stylized facts. In one, tradables are "special" because they suffer disproportionately (compared to non-tradables) from the institutional weakness and contracting incompleteness that characterize low-income environments. In the other, tradables are "special" because they suffer disproportionately from the market failures (information and coordination externalities) that block structural transformation and economic diversification. In both cases, an increase in the relative price of tradables acts as a second-best mechanism to (partially) alleviate the distortion and spur growth. While I am unable to discriminate sharply between the two theories and come down in favor of one or the other, I present some evidence that suggests that these two sets of distortions do affect tradable activities more than they do non-tradables. This is a necessary condition for my explanations to make sense.

In the penultimate section of the paper I develop a simple growth model to elucidate how the mechanisms I have in mind might work. The model is that of a small open economy in which both tradable and non-tradable sectors suffer from an economic distortion. For the purposes of the model, whether the distortion is of the contracting kind or of the conventional market-failure kind is of no importance. The crux is the relative magnitude of the distortions in the two sectors. I show that when the distortion in tradables is larger, the size of the tradable sector is too small. An outward transfer, which would normally reduce domestic welfare, can have the reverse effect because it increases the equilibrium relative price of tradables and can increase economic growth. The model clarifies how changes in relative prices can produce growth effects in the presence of distortions that affect sectors differentially. It also clarifies the sense in which the real exchange rate is a "policy" variable: changing the level of the real exchange rate requires complementary policies (here the size of the inward or outward transfer).

I summarize and discuss some policy issues in the concluding section of the paper.

2 Undervaluation and growth: the evidence

2.1 An undervaluation index

I compute an index of overvaluation in three steps. First, I use data on exchange rates ($XRAT$) and PPP conversion factors (PPP) from Penn World Tables 6.2 (Heston, Summers, and Atina 2006) to calculate a "real" exchange rate (RER):

$$\ln RER_{it} = \ln(XRAT_{it}/PPP_{it})$$

where i is an index for countries and t is an index for (5-year) time periods. $XRAT$ and PPP are expressed as national currency units per U.S. dollar. When RER is greater than one it indicates that the value of the currency is lower (more depreciated) than is indicated by purchasing-power parity. However, in practice non-traded goods are also cheaper in poorer countries (as per Balassa-Samuelson), which requires an adjustment. So in the second step I account for the Balassa-Samuelson effect by regressing RER on per-capita GDP ($RGDPCH$):

$$\ln RER_{it} = \alpha + \beta \ln RGDPCH_{it} + f_t + u_{it} \quad (1)$$

where f_t is a fixed effect for time period and u_{it} is the error term. This regression yields an estimated $\hat{\beta} = -0.24$ (with a very high t-statistic around 20), suggesting a strong and well-estimated Balassa-Samuelson effect: when incomes rise by 10 percent, real exchange rates appreciate by around 2.4 percent. Finally, to arrive at my index of undervaluation I take the difference between the actual real exchange rate and the Balassa-Samuelson-adjusted rate:

$$\ln UNDERVAL_{it} = \ln RER_{it} - \ln \widehat{RER}_{it}$$

where $\ln \widehat{RER}_{it}$ is the predicted values from equation (1).

Defined in this way, $UNDERVAL$ is comparable across countries and over time. Whenever $UNDERVAL$ exceeds unity, it indicates that the exchange rate is set such that goods produced at home are cheap in dollar terms: the currency is undervalued. When $UNDERVAL$ is below unity, the currency is overvalued. In what follows I will typically use its logarithmic transform, $\ln UNDERVAL$, which is centered at 0 and has a standard deviation of 0.48 (see Figure 8). The figures I presented above use this index.

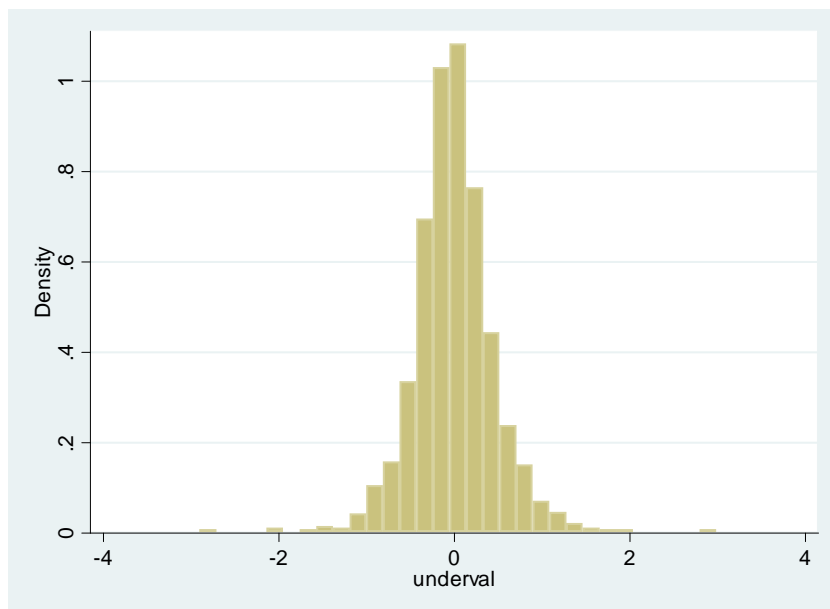


Figure 8: Distribution of $\ln \text{UNDERVAL}$

My procedure is fairly close to that followed in recent work by Johnson, Ostry, and Subramanian (2007). The main difference is that these authors estimate a different cross-section for (1) for each year, whereas I estimate a single panel (with time dummies). My method seems preferable for purposes of comparability over time. I emphasize that my definition of "undervaluation" is based on price comparisons, and differs substantially from an alternative definition which relates to the external balance. The latter is typically operationalized by specifying a small-scale macro model and estimating the level of the (real) exchange rate that would achieve balance-of-payments equilibrium (see for example Razin and Collins 1997 and Elbadawi 1994 for some illustrations.)

2.2 Panel evidence

The data set consists of a maximum of 184 countries and eleven 5-year time periods from 1950-54 through 2000-04. My basic specification for estimating the relationship between undervaluation and growth takes the form:

$$growth_{it} = \alpha + \beta \ln RGDPCH_{it-1} + \delta \ln UNDERVAL_{it} + f_i + f_t + u_{it} \quad (2)$$

This allows for a convergence term (initial income level, $RGDPCH_{it-1}$) and a full set of country and time period dummies (f_i and f_t). Our primary interest lies in $\hat{\delta}$. Given the fixed-effects framework, what I am estimating is the "within" effect of undervaluation, namely the impact of *changes* in undervaluation on changes in growth rates within countries. The advantage of using this approach is that it allows me to control for potential determinants of growth which do not change much over time—such as institutional quality or geography—without introducing them directly in the regression. Any advantage or disadvantage that these time-invariant factors present is absorbed into the fixed effect for each country.

The results are shown on Table 1. When estimated for the panel as a whole, the regression yields a highly significant estimate for δ : 0.017. However, as columns (2) and (3) reveal, this effect operates only for developing countries. In the richer countries of the sample $\hat{\delta}$ is small and statistically indistinguishable from zero, while in the developing countries $\hat{\delta}$ rises to 0.027 and is highly significant. The latter estimate suggests that a 50 percent undervaluation—roughly the magnitude of China’s undervaluation in recent years—is associated with a contemporaneous growth boost (during the same 5-year sub-period) of 1.35 percentage points (0.50×0.027). This is a sizable effect.²

Interestingly, the estimated impact of undervaluation seems to be independent of the time period under consideration. When we split the panel into pre- and post-1980 subperiods, the value of $\hat{\delta}$ remains basically unaffected (columns 4 and 5). This indicates that the channel(s) through which undervaluation works has little to do with the global economic environment; the estimated impact is if anything smaller in the post-1980 era of globalization when markets in rich countries were considerably more open. So the explanation cannot be a simple export-led growth story.

²Prasad et al. (2007) also report a positive growth effect from undervaluation, although they emphasize the growth penalty of overvaluations driven by capital inflows rather than the benefits of undervaluation per se. Easterly (2005) reports insignificant results for his overvaluation measure in a similar fixed-effects panel setting. The differences may be due to a number of reasons: I use a different index to measure undervaluation, have a larger sample of countries and longer time period, and distinguish between developed and developing countries. In addition, Easterly introduces both an overvaluation measure and a black-market premium in his regressions (in addition to a range of other "policy" variables); these two are likely to be collinear, confounding efforts to identify their distinct contributions to growth.

Panel evidence on the growth effects of undervaluation

	(1)	(2)	(3)	(4)	(5)	(6)
	all countries	developed countries (<i>RGDPCH</i> > \$6,000)	developing countries (<i>RGDPCH</i> > \$6,000)	developing countries (<i>RGDPCH</i> > \$6,000) 1950-1979	developing countries (<i>RGDPCH</i> > \$6,000) 1980-2004	developing countries (<i>RGDPCH</i> > \$6,000)
<i>In initial income</i>	-0.030* (-6.62)	-0.053* (-7.30)	-0.039* (-5.44)	-0.062* (-3.95)	-0.066* (-4.83)	-0.027* (-3.67)
<i>In UNDERVAL</i>	0.017* (5.09)	0.004 (0.59)	0.027* (5.73)	0.030* (4.14)	0.025* (3.17)	0.024* (4.37)
<i>In terms of trade</i>						0.014** (2.46)
<i>time dummies</i>	Yes	Yes	Yes	Yes	Yes	Yes
<i>country dummies</i>	Yes	Yes	Yes	Yes	Yes	Yes
<i>no. of observations</i>	1303	513	790	321	469	529

Notes: Robust t-statistics in parentheses. Three countries with extreme observations for *UNDERVAL* have been excluded from the sample (Iraq, Laos, and People's Republic of Korea).

* Significant at the 1% percent level.

** Significant at the 5% percent level

Table 1

As noted in the introduction, the literature on the relationship between exchange rate policy and growth has focused to date largely on the deleterious consequences of large overvaluations. In his survey of the cross-national growth literature, Easterly (2005) warns against extrapolating from large black market premia for foreign currency—for which he can find evidence of harmful effects on growth—to more moderate misalignments in either direction—for which he does not. In this case, however, the evidence strongly suggests that the relationship I have estimated does not rely on outliers, and that it is driven at least as much by the positive growth effect of undervaluation as by the negative effect of overvaluation.

The partial scatter plot associated with column (3) of Table 1 is displayed in Figure 9. Ocular inspection suggests a linear relationship over the entire range of *UNDERVAL* and no obvious outliers in the sample. To check this more system-

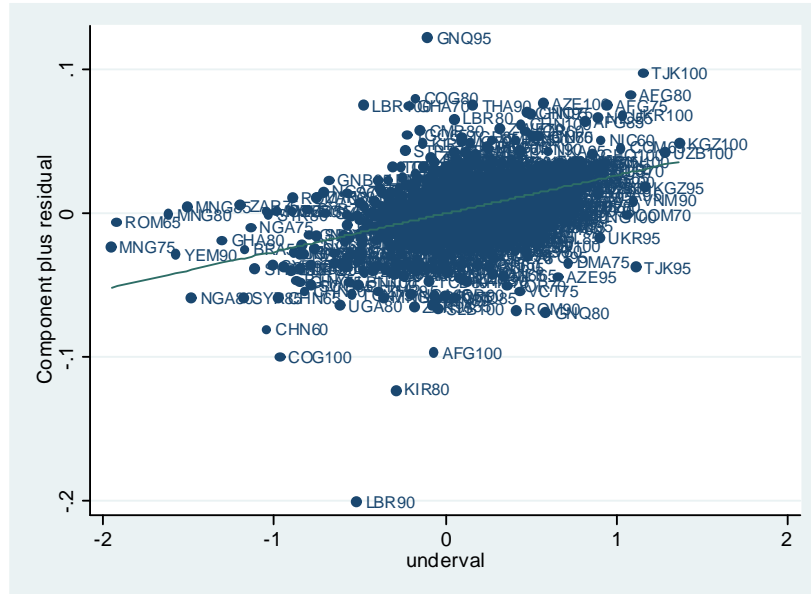


Figure 9: Partial scatterplot of growth against *UNDERVAL*, developing country sample

atically, I estimate the regression for successively narrower ranges of *UNDERVAL*. The results are shown in Table 2. Column (1) of Table 2 reproduces the baseline result from Table 1. Column (2) excludes all observations with *UNDERVAL* < 1.50 (i.e., overvaluations greater than 150%), column (3) excludes observations with *UNDERVAL* < 1.00 , and so on. The final column restricts the range to undervaluations or overvaluations that are smaller than 50%. The remarkable finding is that these sample truncations do very little to the estimated coefficient on $\ln \text{UNDERVAL}$. The coefficient we get when we eliminate all overvaluations greater than 25% is identical to that for the entire sample (column 5). And the coefficient we obtain when we eliminate all under- or overvaluations above 50% is still highly significant.

Testing for outliers and asymmetries

	(1)	(2)	(3)	(4)	(5)	(6)
	baseline	<i>UNDERVAL</i> greater than -1.50	<i>UNDERVAL</i> greater than -1.00	<i>UNDERVAL</i> greater than -0.50	<i>UNDERVAL</i> greater than -0.25	<i>UNDERVAL</i> between -0.50 and 0.50
<i>coefficient on ln UNDERVAL</i>	0.027* (5.73)	0.033* (6.96)	0.034* (6.92)	0.030* (5.55)	0.027* (3.84)	0.021* (3.35)
<i>no. of observations</i>	790	785	774	725	635	626

Notes: Same as Table 1.

Table 2

2.3 Causality

An obvious objection to these results is that they do not capture a relationship that is truly causal. The real exchange rate is the relative price of tradables to non-tradables in an economy, and as such is an *endogenous* variable. Does it make sense to stick it (or some transformation thereof) on the right-hand side of a regression and talk about its effect on growth? Perhaps not in a world where governments did not care about the real exchange rate and which left it to be determined purely by market forces. But we do not live in such a world, and with the exception of a handful of advanced countries, most governments pursue a variety of policies with the explicit goal of affecting the real exchange rate. Fiscal policies, capital-account policies, and intervention policies are part of an array of such policies. In principle, moving the real exchange rate requires changes in real quantities, but we have known for a long time that even policies that affect nominal magnitudes can do the trick—for a while. One of the key findings of the open-economy macro literature is that nominal exchange rates and real exchange rates move quite closely together, except in highly inflationary environments. Levy-Yeyati and Sturzenegger (2007) have recently shown that sterilized intervention can and does affect the real exchange rate in the short-to medium-term. So interpreting our results as saying something about the growth effects of different exchange-rate management strategies seems plausible.

We still have to worry about reverse causation and omitted variables bias, of course. The real exchange rate may respond to a variety of shocks besides policy, and these may confound the interpretation of $\hat{\delta}$. But it is difficult to think of plausible

sources of bias that would generate the *positive* relationship between undervaluation and growth I have documented. To the extent that endogenous mechanisms are at work, they generally create a bias that works against these findings. Economic growth is expected to appreciate the exchange rate on standard Balassa-Samuelson grounds (which we control for anyhow by using *UNDERVAL*). Shocks that depreciate ("undervalue") the real exchange rate tend to be shocks that are bad for growth on conventional grounds—a reversal in capital inflows or a terms of trade deterioration for example. Good news about the growth prospects of an economy are likely to attract capital inflows and *appreciate* ("overvalue") the real exchange rate. So it is unlikely that our positive coefficient results from the effect of growth on the real exchange rate. If there is reverse causality, it would likely lead us to *underestimate* δ . Note that when we include the terms of trade in our basic specification (column 6 of Table 1), the results are unaffected. As expected, improvements in the terms of trade have a positive effect on growth, but the coefficient on *UNDERVAL* remains significant and essentially unchanged.

I provide a further check on specification and endogeneity biases by presenting the results of dynamic panel estimation using GMM. These models use lagged values of regressors (in levels and in differenced form) as instruments for right-hand side variables and also allow lagged endogenous (left-hand side) variables as regressors in short panels (Arellano and Bond 1991, Blundell and Bond 1998; see Roodman 2006 for an accessible user's guide). Table 3 presents results for both the "difference" and "system" versions of GMM. In each case, the estimated coefficient on *UNDERVAL* is statistically significant and within the same ballpark of estimates reported earlier.

Dymanic panel estimation of the growth effects of undervaluation
(Developing country sample)

	(1)	(2)
	Difference GMM	System GMM
<i>lagged growth</i>	-0.037 (-0.76)	0.331* (5.76)
<i>ln initial income</i>	-0.108* (-6.96)	0.005 (1.00)
<i>ln UNDERVAL</i>	0.027* (5.06)	0.015** (2.09)
<i>time dummies</i>	Yes	Yes
<i>no. of countries</i>	104	125
<i>avg. obs. per country</i>	5.2	5.9
<i>Hansen test of overid. restrictions</i> <i>prob > chi-squared</i>		0.424
<i>Arellano-Bond test of AR(2)</i> <i>prob>z</i>	0.146	0.653
<i>no. of lags</i>	maximum	maximum

Notes: Same as Table 1.

Table 3

2.4 Evidence from growth accelerations

A different way to look at the cross-national evidence is to look at countries that have experienced noticeable growth spurts and to ask what has happened to *UNDERVAL* before, during, and after these growth accelerations. This way of parsing the data throws out a lot of information, but has the virtue that it focuses us on a key question: have those countries that managed to engineer sharp increases in economic growth done so on the back of undervalued currencies?

In Hausmann, Pritchett, and Rodrik (2005), my colleagues and I identified 83 distinct instances of growth accelerations. In each one these instances, growth picked

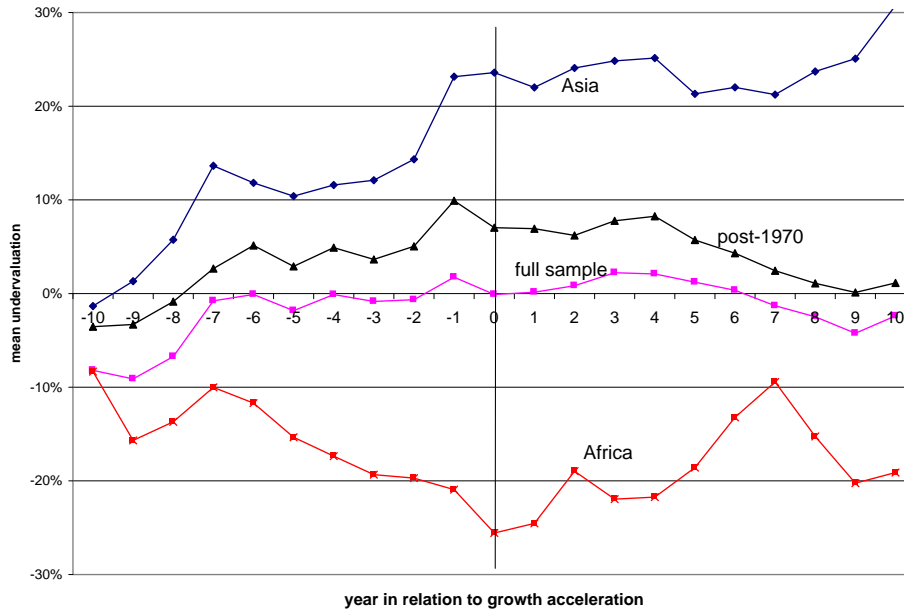


Figure 10: Growth accelerations and *UNDERVAL*

up by 2 percentage points or more and the spurt was sustained for at least eight years. Figure 10 displays the average values of *UNDERVAL* for a 21-year window centered on the date of the growth acceleration (the two ten-year periods before and after the acceleration plus the year of the acceleration). The chart shows interesting patterns in the trend of *UNDERVAL*, but is especially telling with respect to the experience of different subgroups.

For the entire sample of growth accelerations, there is a noticeable, if moderate decline in overvaluation in the decade prior to the onset of the growth spurt. The increase in *UNDERVAL* is of the order of 10 percent, and is sustained into the first five years or so of the episode. Since these growth accelerations include quite a few rich countries in the 1950s and 1960s, I next restrict the sample to growth accelerations that occurred after 1970. There is a much more distinct trend in *UNDERVAL* for this sub-sample: the growth spurt takes place after a decade of steady increase in *UNDERVAL* and takes place immediately after the index reaches its peak value (at an undervaluation of 10 percent). The third cut is to focus on just Asian countries. These countries reveal the most pronounced trends, with *UNDERVAL* pointing to an average undervaluation of more than 20 percent at the start of the growth

acceleration. Moreover, undervaluation is sustained into the growth episode, and in fact increases further by the end of the decade. This is to be contrasted to the experience of African growth accelerators, for which the image is virtually the mirror opposite. In Africa, the typical growth acceleration takes place after a decade of increased *overvaluation* and the timing of the acceleration coincides with the peak of the overvaluation.

As is well known, Asian growth accelerations have proved significantly more impressive and lasting than African ones. The contrasting behavior of the real exchange rate may offer an important clue as to the sources of the difference.

3 Understanding the importance of the real exchange rate

The real exchange rate is a relative price: it represents the price of traded good in terms of non-traded goods:

$$RER = P_T/P_N$$

Why might an increase in this relative price have a causal impact on economic growth, as my results suggest it does? An increase in *RER* enhances the relative profitability of the traded-goods sector and causes it to expand (at the expense of the non-traded sector). There is no generally accepted theory that explains why this in itself would generate higher growth. Any such theory would have to explain why tradables are "special" from the standpoint of growth. This is the sense in which my results open an important window on the mechanisms behind the growth process. If we can understand the role that tradables play in driving growth, we may be able to get a better grip on the policies that promote (and hamper) growth.

While there is potentially a very large number of stories that may account for the role of tradables, two clusters of explanations deserve attention in particular. One focuses on weaknesses in the contracting environment, and the other on market failures in modern, industrial production. Both types of explanation have been common in the growth and development literature, but in the present context we need something on top. We need to argue that tradables suffer disproportionately from these shortcomings, so that absent a compensating policy, developing economies devote too few of their resources to tradables and grow less rapidly than they should. An increase in *RER* can then act as a second-best mechanism for spurring tradables and for generating more rapid growth.

The two clusters of explanations are represented schematically in Figures 11 and 12. I discuss them in turn in the rest of this section. The mechanics of how changes in relative prices can generate growth in the presence of sectorally differentiated distortions is discussed in the following section.

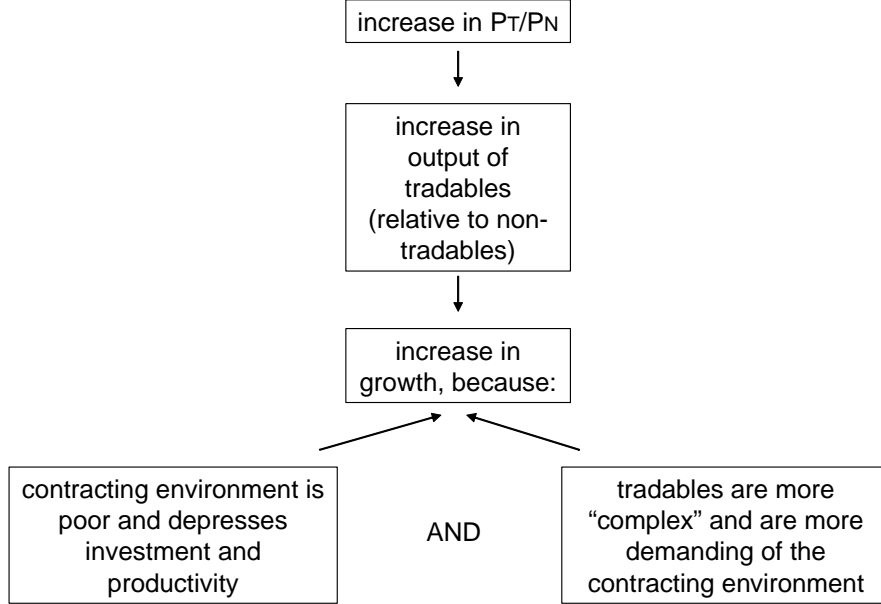


Figure 11: Undervaluation as a second-best mechanism for alleviating institutional weakness

3.1 Explanation 1: Bad institutions "tax" tradables more

The idea that poor institutions keep incomes low and explain—at least in part—the absence of economic convergence is by now widely accepted (North 1990, Acemoglu, Johnson, and Robinson 2001). Weak institutions create low private appropriability of returns to investment through a variety of mechanisms: contractual incompleteness, hold-up problems, corruption, lack of property rights, and poor contract enforcement. The resulting wedge between private and social returns in turn blunts the incentives for accumulation and technological progress alike.

Now suppose that this problem is more severe in tradables than it is in non-tradables. This is a plausible supposition since production systems tend to be more “complex” and round-about in tradables, placing greater premium on contractability

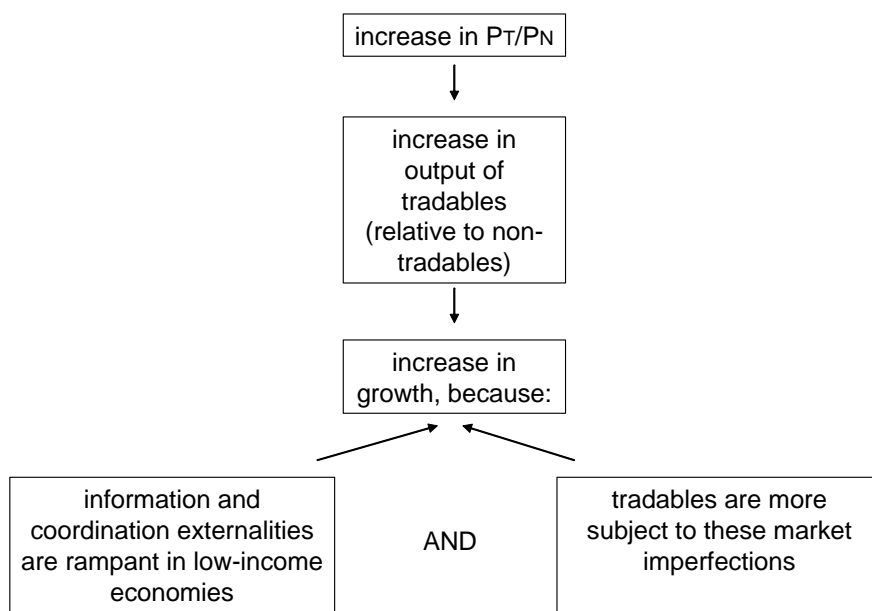


Figure 12: Undervaluation as a second-best mechanism for alleviating market failures

and reliable third-party enforcement. A barber needs to rely on little more than a few tools, a chair, and his ingenuity to sell his services. A manufacturing firm needs the cooperation of multitudes of suppliers and customers, plus financial and legal support. Lousy institutions therefore impose a higher "tax" on tradables—especially modern tradables. This results in both a static misallocation of resources that penalizes tradables, and a dynamic distortion in the form of lower-than-socially optimal investment in tradables. An increase in the relative price of tradables can improve static efficiency and enhance growth in second-best fashion by eliciting more investment in tradables at the margin (as I will show in the following section).

What about evidence? There is a fair amount of empirical work, both across countries and across industries, which presents suggestive evidence on the disproportionate cost borne by tradables—as a whole or in part—in the presence of weak institutions.

- Across countries, lower quality institutions (measured by indices of the rule of law, contract enforcement, control of corruption) are associated with smaller ratios of trade to GDP (“openness”). See for example Anderson and Mercouiller (2002), Rodrik, Subramanian, and Trebbi (2004), Rigobon and Rodrik (2005), Meon and Sekkat (2006), Berkowitz et al. (2006), and Ranjan and Lee

(forthcoming).

- Across different categories of tradable goods, more "institution-intensive" tradables are prone to larger effects. Meon and Sekkat (2006) find that the relationship they identify holds for manufactured exports, but not for non-manufactured exports, while Ranjan and Lee (forthcoming) find the effect is stronger for differentiated goods than for homogenous goods.
- Institutional weakness interacts with contract-intensity of goods to play a role in determining comparative advantage. Levchenko (2006), Berkowitz et al. (2006), and Nunn (2007) find that countries with poor institutions have comparative *disadvantage* in institutions-intensive/more complex/relationship-intensive products.

To provide more direct evidence, I use unpublished data kindly provided by Nathan Nunn to compare directly the contract-intensiveness of tradables and non-tradables. Nunn (2007) was interested to check whether the differences in institutional quality across countries helps determine patterns of comparative advantage. He reasoned that relationship-specific intermediate inputs, defined as inputs that are not sold on exchanges and/or do not have reference prices (as in Rauch 1999), are more demanding of the contractual environment. In his original paper, Nunn (2007) used measures of relationship-specificity for tradables alone, since his main concern was with comparative advantage. But he collected similar data for services as well, which is what I use to carry out the tradables/non-tradables comparison.

The top panel of Table (4) shows the shares of intermediates that are relationship-specific in traded and non-traded industries. (These numbers are based on U.S. input/output tables.) At first sight, these numbers seem to conflict with what my argument requires, insofar as they show that the inputs used in tradables are less relationship-specific, and hence less demanding of the institutional environment. But this is misleading because it overlooks the fact that traded goods tend to have much higher intermediate input shares in gross output. This is shown in the middle panel of the table (this time relying on input-output tables from Brazil). When we put the two pieces together, we get the results in the bottom panel of Table (4), which shows that on balance tradable goods rely on relationship-specific inputs to a much greater extent. The numbers for the two sets of goods differ by a factor of between 2 and 3.

Tradables use intermediates that tend to be less relationship-specific ...

	Traded	Non-traded
share of intermediates not sold on exchange and not reference-priced (unweighted average)	49.6%	75.1%
share of intermediates not sold on exchange (unweighted average)	87.3%	96.4%

Calculated from data provided by Nathan Nunn, based on Nunn (2006)

but tradables rely more on intermediate inputs ...

	Traded	Non-traded
Inputs: share of intermediates in total output	64.3%	35.1%
Outputs: share of inter-industry sales in total output	58.4%	29.4%

From Brazil's input-output table, 1996

So on balance relationship-specific intermediates account for a much larger share of total output in tradables

	Traded	Non-traded
share in gross output of intermediates not sold on exchange and not reference-priced (unweighted average)	17.9%	7.5%
share in gross output of intermediates not sold on exchange (unweighted average)	31.5%	9.7%

Calculated from unpublished data provided by Nathan Nunn (using US VA shares).

Table 4

Hence the evidence that institutional and contracting shortcomings, the bane of every developing society, impose a greater tax on the traded sector than it does on the non-traded sector is fairly compelling. It remains to be seen how this creates a growth-promoting role for real exchange rate policy. I will develop this next point in the next section. But before that we turn to the second category of explanations.

3.2 Explanation 2: Market failures predominate in tradables

The second hypothesis about why the real exchange rate matters is that tradables are particularly prone to the market failures with which development economists have long been preoccupied. A short list of such market failures would include:

- learning externalities: valuable technological, marketing, and other information spills over to other firms and industries
- coordination externalities: getting new industries off the ground requires lumpy and coordinated investments upstream, downstream or sideways.
- credit market imperfections: entrepreneurs cannot finance worthwhile projects because of limited liability and asymmetric information.

- wage premia: monitoring, turnover, and other costs keep wages above market-clearing levels and employment remains low.

These and similar problems can plague all kinds of economic activity in developing countries, but arguably their effects are felt much more acutely in tradables. If so, output and investment levels in tradables would be suboptimal. Real exchange rate depreciations would promote capacity expansion in tradables and increase growth. Note that once again, this is a second-best argument for undervaluation. First best policy would consist of identifying distinct market failures and applying the appropriate Pigovian remedies. Undervaluation is in effect a substitute for industrial policy.

What is the evidence? By their very nature, market failures are difficult to identify. It is difficult to provide direct evidence that some kinds of good are more prone to market failures than others. But the basic hypothesis is quite plausible. A close look at the processes behind economic development yields plenty of indirect and suggestive evidence. Economic development consists of structural change, investment in new activities, and the acquisition of new productive capabilities. As countries grow, the range of tradable goods that they produce expands (Imbs and Wacziarg 2003). Rich countries are rich because not just because they produce traditional goods more productively, but also because they produce different goods (Hausmann, Hwang, and Rodrik 2007). The market failures listed above are likely to be much more severe in new lines of production—those needed to increase economy-wide productivity—than in traditional ones. New industries require "cost discovery" (Hausmann and Rodrik 2003), learning-by-doing, and complementary economic activities to get established. They are necessarily risky and lack track records. These features make them fertile ground for learning and coordination externalities.

3.3 Discussion

Unfortunately it is not easy to distinguish empirically between the two broad hypotheses I have outlined above. In principle, if we could identify the goods that are most affected by each of these two categories of imperfections—contractual and market failures—we could run a horse race between the two hypotheses by asking which goods among them are more strongly associated with economic growth. Nunn's (2007) data are a useful beginning for ranking goods by degree of contract-intensity. Perhaps an analogous set of rankings could be developed for market failures using the commodity categorization in Hausmann and Rodrik (2003), which are loosely based on the prevalence of learning externalities. But ultimately I doubt that we could have a sufficiently fine and reliable distinction among goods to enable us to discriminate between the two stories in a credible manner.

Rich countries differ from poor countries both because they have better institutions and because they have learned how to deal with market imperfections. Producers of traded goods in developing economies suffer on both counts.

4 A simple model of real exchange rates and growth

I argued in the previous section that when tradables are affected disproportionately by pre-existing distortions, real exchange rate depreciations can be good for growth. I now develop a simple model to illustrate the mechanics behind this. I will consider an economy in which there exist "taxes" on both traded and non-traded sectors that drive a wedge between private and social marginal benefits. When the tax on tradables is larger (in ad-valorem terms) than the tax on non-tradables, the economy's resources are mis-allocated, the tradable sector is too small, and the growth rate is sub-optimal. Under these circumstances real exchange rate depreciations have a growth-promoting effect

4.1 Consumption and growth

Consumers consume a single final good, which as we shall see below is produced using a combination of traded and non-traded inputs. Their intertemporal utility function is time-separable and logarithmic, and takes the form

$$u = \int \ln c_t e^{-\rho t} dt$$

where c_t is consumption at time t and ρ is the discount rate. Maximizing this subject to an intertemporal budget constraint yields the familiar growth equation

$$\frac{\dot{c}_t}{c_t} = r_t - \rho \tag{3}$$

where r is the real interest rate (or the marginal product of capital). The economy's growth is increasing in the rate of return to capital (r), which is the feature that we will exploit in the rest of this section.

4.2 Production

I assume that the economy produces the single final good using traded and non-traded goods as the sole inputs (y_T and y_N respectively). The production function for the

final good (y) is a Cobb-Douglas aggregate of these two inputs. In addition, in order to allow for endogenous growth (while maintaining perfect competition throughout), I assume that capital produces external economies in the production of the final good. With these assumptions, the production function of the representative final-good producer can be written as follows:

$$y = \bar{k}^{1-\phi} y_T^\alpha y_N^{1-\alpha} \quad (4)$$

where \bar{k} is the economy's capital stock at any point in time (treated as exogenous by each final-goods producer), and α and $1-\alpha$ are the shares of traded and non-traded goods, respectively, in the production costs of the final good ($0 < \alpha < 1$). For convenience, I choose the exponent on \bar{k} to be a parameter ($1-\phi$) that will make aggregate output linear in capital—as we will see shortly—and which therefore considerably simplifies the comparative dynamics of the model. I also omit time subscripts for ease of notation.

Traded and non-traded goods are in turn produced using capital alone and under decreasing returns to scale. These production functions take the following simple form:

$$q_T = A_T k_T^\phi = A_T (\theta_T \bar{k})^\phi \quad (5)$$

$$q_N = A_N k_N^\phi = A_N ((1 - \theta_T) \bar{k})^\phi \quad (6)$$

where k_T and k_N denote the capital stock employed in traded and non-traded sectors, θ_T is the share of total capital employed in tradables, and $0 < \phi < 1$. To justify decreasing returns to capital in the sectoral production functions (i.e., the fact that $\phi < 1$), we could suppose that there are other, sector-specific factors of production employed in each sector which are fixed in supply.

By definition, non-traded goods that are used as inputs in the final-goods sector can only be sourced domestically. And since non-traded goods do not enter consumption directly, we have

$$q_N = y_N \quad (7)$$

With respect to traded goods, we allow the economy to receive a transfer from the rest of the world (or to make a transfer to it). Let b stand for the magnitude of the inward transfer. Then, the material-balances equation in tradables is given by

$$q_T + b = y_T$$

It will be more convenient to express b as a share (γ) of the total domestic demand for tradables. That is, $b = \gamma y_T$. The equality between demand and supply in tradables then becomes

$$\frac{1}{1-\gamma} q_T = y_T \quad (8)$$

When the economy makes an outward transfer, γ will be negative. I will use γ as a shifter that alters the equilibrium value of the real exchange rate.

Using equations (4)-(8), the aggregate production function can be expressed as

$$y = (1-\gamma)^{-\alpha} A_T^\alpha A_N^{1-\alpha} \theta_T^{\alpha\phi} (1-\theta_T)^{(1-\alpha)\phi} \bar{k} \quad (9)$$

Net output, defined as \tilde{y} , differs from gross output insofar as the economy makes a payment to the rest of the world for the transfer b (or receives a payment from it if b is negative). We express this payment in general form, assuming that it is a share σ of the transfer's contribution to gross output, i.e. $\sigma \times (\partial y / \partial b) \times b = \sigma \times (\partial y / \partial y_T) \times \gamma y_T = \sigma \times (\alpha / y_T) y \times \gamma y_T = \sigma \alpha \gamma y$. Net output \tilde{y} equals $y - \sigma \alpha \gamma y = (1 - \sigma \alpha \gamma) y$. Therefore, using (9),

$$\tilde{y} = (1 - \sigma \alpha \gamma) (1 - \gamma)^{-\alpha} A_T^\alpha A_N^{1-\alpha} \theta_T^{\alpha\phi} (1 - \theta_T)^{(1-\alpha)\phi} \bar{k} \quad (10)$$

This way of expressing the payment for the transfer allows a wide variety of scenarios. The transfer's contribution to net output is maximized when $\sigma = 0$, that is when b is a pure transfer (a grant). The contribution becomes smaller as σ increases.

Note that the production function ends up being of the Ak type, i.e. linear in capital. This gives us an endogenous growth model with no transitional dynamics. The (net) marginal product of capital (r) is $\partial \tilde{y} / \partial \bar{k}$, or:

$$r = (1 - \sigma \alpha \gamma) (1 - \gamma)^{-\alpha} A_T^\alpha A_N^{1-\alpha} \theta_T^{\alpha\phi} (1 - \theta_T)^{(1-\alpha)\phi} \quad (11)$$

which is independent of the capital stock, but depends on the allocation of capital between tradables and non-tradables, θ_T (as well as on the net value of the transfer from abroad).

Since the economy's growth rate will depend on r , it is important to know how r depends precisely on θ_T . Log-differentiating this expression with respect to θ_T , we get

$$\frac{d \ln r}{d \theta_T} \propto \left[\left(\frac{\alpha}{\theta_T} \right) - \left(\frac{1-\alpha}{1-\theta_T} \right) \right]$$

with

$$\frac{d \ln r}{d \theta_T} = 0 \Leftrightarrow \theta_T = \alpha$$

In other words, the return to capital is maximized when the share of the capital stock that the economy allocates to tradables (θ_T) is exactly equal to the input share of tradables in final production (α). This rate of return, and ultimately the economy's growth rate, will be suboptimal when tradables receive a lower share of capital. We will next analyze the circumstances under which such inefficiencies obtain.

4.3 Sectoral allocation of capital

The allocation of capital between traded and non-traded sectors will depend both on the relative demand for the two goods and on the relative profitability of producing them. Consider the latter first. In equilibrium, capital will be allocated such that its (private) value marginal product is equalized in the two sectors. As discussed previously, we presume that each sector faces an "appropriability" problem, arising from either institutional weaknesses or market failures or both. We model this by assuming that private producers can retain only a share $(1 - \tau_i)$ of the value of producing each good ($i = T, N$). In other words, τ_T and τ_N are the effective "tax" rates faced by producers in their respective sectors. Let the relative price of traded goods (p_T/p_N) be denoted by R . This is our index of the "real exchange rate." The equality between the value marginal product of capital in the two sectors can then be expressed as

$$(1 - \tau_T)R\phi A_T(\theta_T \bar{k})^{\phi-1} = (1 - \tau_N)\phi A_N [(1 - \theta_T)\bar{k}]^{\phi-1}$$

which simplifies to

$$\left(\frac{\theta_T}{1 - \theta_T}\right)^{\phi-1} = \left(\frac{1 - \tau_N}{1 - \tau_T}\right) \frac{1}{R} \frac{A_N}{A_T} \quad (\text{SS}) \quad (12)$$

This is a supply-side relationship which says that the share of capital that is allocated to tradables increases with the relative profitability of the traded-goods sector. This relative profitability in turn increases with R , τ_N , and A_T , and decreases with τ_T , and A_N (remember that $\phi - 1 < 0$). The SS schedule is a positively sloped relationship between θ_T and R , and is shown in the accompanying figure.

Now turn to the demand side. In view of the Cobb-Douglas form of the production function for the final good, the demands for the two intermediate goods are given by

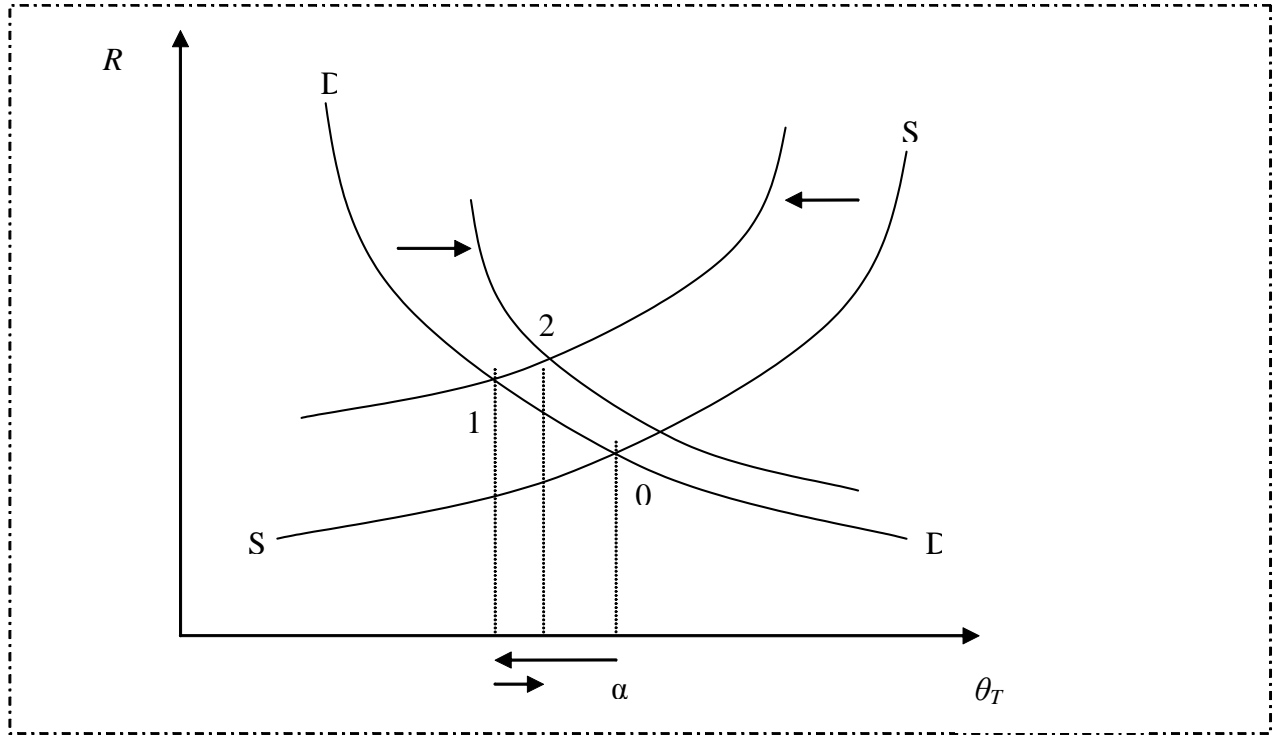
$$\alpha y = p_T y_T = p_T \left(\frac{1}{1-\gamma} \right) q_T = p_T \left(\frac{1}{1-\gamma} \right) A_T (\theta_T \bar{k})^\phi$$

$$(1-\alpha)y = p_N y_N = p_N q_N = p_N A_N ((1-\theta_T)\bar{k})^\phi$$

Dividing these two expressions and rearranging terms, we get

$$\left(\frac{\theta_T}{1-\theta_T} \right)^\phi = (1-\gamma) \left(\frac{\alpha}{1-\alpha} \right) \frac{1}{R} \frac{A_N}{A_T} \quad (\text{DD}) \quad (13)$$

This is a demand-side relationship between θ_T and R , and is shown as the DD schedule in the figure. This schedule is negatively sloped since an increase in R makes traded goods more expensive and reduces the demand for capital in that sector. Note that a reduction in γ (smaller inward transfer) shifts this schedule to the right: it increases θ_T at a given R , or increases R at a given θ_T .



The equilibrium

4.4 Equilibrium and implications

The equilibrium levels of θ_T and R are given by the point of intersection of the SS and DD schedules. We note several things about the nature of this equilibrium. To begin with, suppose that we are at an initial position where the economy does not receive a transfer from abroad ($\gamma = 0$). If there are no appropriability problems in either of the intermediate goods sectors such that $\tau_T = \tau_N = 0$, then it is relatively easy to confirm that the equilibrium is one where $\theta_T = \alpha$. This ensures that the return to capital and growth are maximized. Now suppose that τ_T and τ_N are positive, but that their magnitude is identical ($\tau_T = \tau_N > 0$). We can see from equation (11) that the equilibrium remains unaffected. As long as the distortion affects traded and non-traded goods equally, θ_T remains at its growth-maximizing level.

Things are different when $\tau_T \neq \tau_N$. Suppose that $\tau_T > \tau_N$, which is the case that I have argued previously is the more likely situation. Relative to the previous equilibrium, this entails a leftward shift in the SS schedule. In the new equilibrium, θ_T is lower (and R is higher). Because $\theta_T < \alpha$, the economy pays a growth penalty. Note that the endogenous depreciation of the real exchange rate (R) plays a compensatory role, but it does so only partially.

Starting from this new equilibrium (where $\tau_T > \tau_N$ and $\theta_T < \alpha$), it is entirely possible that a negative transfer would improve the economy's growth. That is because a reduction in γ leads to an increase in the equilibrium level of the real exchange rate, and moves θ_T closer to α . In terms of the figure, a fall in γ shifts the DD schedule to the right, and causes both R and θ_T to rise. Whether growth also increases ultimately remains uncertain because the reduction in γ also has a direct negative effect on growth (see equation 11). But for σ sufficiently high, we can always generate cases where this is on balance growth promoting. In such cases, the real exchange rate depreciation generated by the negative external transfer becomes a second-best instrument to offset the growth costs of the differential distortion on tradables.

5 Concluding remarks

The main point of this paper can be stated succinctly. Tradable economic activities are "special" in developing countries. These activities suffer disproportionately from the institutional and market failures that keep countries poor. Sustained real exchange rate depreciations increase the relative profitability of investing in tradables, and act in second-best fashion to alleviate the economic cost of these distortions. That is

why episodes of undervaluation are strongly associated with higher economic growth.

There is an obvious parallel between the argument I have developed here and the results presented in the recent paper by Prasad, Rajan, and Subramanian (2007). These authors note that fast-growing developing countries have tended to run current account surpluses rather than deficits. This runs counter to the view that developing countries are constrained by external finance, and with the presumption that capital inflows supplement domestic saving and enable more rapid growth. One of the explanations Prasad et al. (2007) advance is that capital inflows appreciate the real exchange rate and hurt growth through reduced investment incentives in manufactures. They also provide some evidence on this particular channel. Even though Prasad et al. (2007) focus on the costs of overvaluation rather than the benefits of undervaluation, their concern with the real exchange rate renders their paper complementary to this one.

A maintained hypothesis in the present paper is that the real exchange rate is a policy variable. Strictly speaking, this is not true of course as the real exchange rate is a relative price and is determined in general equilibrium along with all other relative prices. But governments have a variety of instruments at their disposal to influence the level of the real exchange rate, and the evidence is that they use them. Maintaining a more depreciated real exchange rate requires higher saving relative to investment, or lower expenditures relative to income. This can be achieved via fiscal policy (a large structural surplus), incomes policy (redistribution of income to high savers through real wage compression), saving policy (compulsory saving schemes and pension reform), capital-account management (taxation of capital account inflows, liberalization of capital outflows), or currency intervention (building up foreign exchange reserves). Experience in East Asia as well as elsewhere (e.g. Tunisia) shows that countries that target real exchange rates ("competitiveness") can have a fair amount of success.

But it is worth emphasizing once again that real-exchange rate policy is only second-best in this context. One of the side effects of maintaining high real exchange rates is a surplus on the current account (or a smaller deficit). This obviously has effects on other countries. Were all developing countries to follow this strategy, advanced countries would have to accept living with the corresponding deficits. This is a major issue of contention in U.S.-China economic relations at present. Moreover, when some developing countries follow this strategy while others do not (as in Asians versus the rest), the growth penalty incurred by the latter become larger as their traded sector shrinks even further under the weight of Asian competition.

Conceptually, the first-best strategy is clear, if fraught with practical difficulties. Eliminating the institutional and market failures in question would do away with

the policy dilemmas—but recommending this strategy amounts to telling developing countries that the way to get rich is to get rich. A more practical approach is to subsidize tradables production directly, rather than indirectly through the real exchange rate. Note that a depreciated real exchange rate is equivalent to a production subsidy *plus* a consumption tax on tradables. The direct strategy of subsidizing production of tradables achieves the first without the second. Hence it avoids the spillovers to other countries. A production subsidy on tradables boosts exports and imports simultaneously (provided the exchange rate and/or wages are allowed to adjust to equilibrate the current account balance) and therefore need not come with a trade surplus.

However, it goes without saying that production subsidies have their own problems. Fine-tuning them to where the perceived distortions are would amount to a highly intricate form of industrial policy, with all the attendant informational and rent-seeking difficulties. Even if that were not a problem, the strategy would come into conflict with existing WTO rules that prohibit export subsidies. There is, it appears, no easy alternative to exchange-rate policy.

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