Explaining How Real Exchange Rates Move in Growing Economies Using Labor Surplus

Kue Peng Chuah*

Prepared for the Central Bank of Sri Lanka 6^{th} International Research Conference
12 December 2013

Abstract

There are robust empirical evidence that the Balassa-Samuelson hypothesis (BSH) is not satisfied in the developing countries. To explain this empirical fact, this paper makes two contributions. First, I propose a simple two-sector model that dampens the BSH by introducing a countervailing channel driven by "labor surplus" (the large supply of low-wage workers in the traditional sector). The reallocation of labor surplus to the productive tradable sector leads to rapid growth while containing the appreciation of the real exchange rate. This captures an essential feature of the growth process in developing countries. However, the dampening effect diminishes over time because labor surplus is exhausted as the economy grows. A testable implication of the model is that the BSH depends on the labor surplus. Second, I present empirical evidence consistent with the model. The BSH is suppressed when there is a sizeable pool of labor surplus to draw from, whereas the BSH is effective when this factor diminishes below a certain level. Additionally, I find that capital controls may help dampen the BSH. The theoretical and empirical results suggest that the nature of the relationship between the real exchange rate and income depends on the stage of development, which follows from the changing structure of the economy.

Keywords: Real exchange rates, growth, labor surplus, Balassa-Samuelson effect
JEL classification: E31, F31, J6, O1, O4

*I am grateful to Olivier Jeanne for invaluable comments and guidance. For useful discussions, I thank Metin Uyanik and James Lake; and for comments and encouragement, I thank participants at the Central Bank of Sri Lanka 6^{th} International Research Conference, especially Dr. Ananda Jayawickrama. The paper was also presented at the Bank Negara Malaysia Research Seminar (March 2013) and the Singapore Economic Review Conference (August 2013). All errors are my sole responsibility. The views expressed in the paper are those of the author and do not reflect the views of Bank Negara Malaysia. Contact details: Bank Negara Malaysia, Jalan Dato Onn, 50480, Kuala Lumpur, Malaysia; chuahkp@bnm.gov.my