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

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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
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