ABSTRACT

Real exchange rate is one of the key factors in the context of international trade and globalization. The relationship of real exchange rate on economic growth is critical for export growth in open-economy countries. The view of Washington Consensus says misalignments on real exchange rate might be the reason for economy growing slowly. A bunch of empirical studies show that overvalued real exchange rate hindered exports that leads to slow economic growth. Meanwhile, the undervalued real exchange rate is still a matter of debate regarding the potential positive effects that will be generated through export incentives. Overvaluation and undervaluation of the real exchange rate are defined as exchange rate misalignments.

This study aims to analyze the effect of exchange rate misalignments on economic growth through productivity and investment channels that will provide export incentives in the tradable goods sector. In determining the degree of exchange rate misalignments, this study runs the Vector Error Correction Model method to obtain the value of misalignments from the estimation results of the dependent variable real exchange rate. In analyzing the effect of exchange rate misalignments on economic growth, this study employs System GMM with Solow-Swan growth model. This study analyzed thirty countries with the classification of developed and developing countries in the data range from 1970-2019. The results showed no positive effect of exchange rate misalignments on economic growth. However, the observation of a non-linear relationship on real exchange rate misalignments on economic growth shows that there is a positive effect at low degrees of undervaluation. These results suggest that keeping the real exchange rate stable and competitive is a relevant macroeconomic policy target.

Keywords: *Exchange Rate Misalignments, Undervaluation, Overvaluation, Economic Growth*