

Some of these arguments seem to apply with even greater force to emerging markets and developing countries. Manufactures, modern services, and non-traditional agriculture are critically important for economic growth in these countries. Countries that have initiated and sustained modern economic growth have often done so on the back of successful expansion of exports. This has required the promotion of tradables through the adoption of supportive policies.

One economic rationale for emphasizing tradables is that the obstacles that impede structural transformation affect predominantly modern, high-productivity economic activities that are tradable.<sup>26</sup> Such obstacles can take the form of government failures, for example weaknesses in property rights and contract enforcement. Or they can come in the form of market failures, such as learning externalities or coordination failures. The first, best response is to eliminate these underlying distortions, but this is often easier said than done. Alternatively, second-best policies promoting tradables ensure that resources move from low- to high-productivity activities, generating economic growth in the process.

This has been China's recent growth strategy, as well as that of Japan, South Korea, Taiwan, and other East Asian tigers before it. In contrast, countries experiencing shrinkage in non-traditional tradables, such as those in Latin America after 1990, have had low rates of economy-wide productivity growth. Even for emerging markets that have followed a less explicit export-led growth strategy than those in Asia, the trend toward sustained real exchange rate appreciation has rekindled old concerns about the "Dutch disease" consequences.

The structure of production depends on the relative profitability of different activities. The real exchange rate, as the relative price of tradables to non-tradables, may therefore shape structural transformation and set the pace of economic

growth. The question is how much weight central banks should attach to the impact of their policies on the real exchange rate.

In principle they can take refuge in the dichotomy between *nominal* and *real* exchange rates and argue that the conduct of monetary policy has implications for the first but not the second. The *real* exchange rate is an endogenous relative price determined by real quantities, namely the balance between domestic saving and domestic investment. Under textbook conditions, the competitiveness of tradables can be divorced from monetary policy.

There are two counter-arguments, one empirical and the other conceptual. The empirical point is that prices tend to be stickier than the exchange rate, as a result of which nominal and real exchange rates tend to move together. Exporters who see the nominal value of the domestic currency rise can be pretty certain that this will have an adverse impact on their profitability over time horizons they care about.

The conceptual point is that economies with large amounts of surplus labor have quasi-Keynesian features, allowing monetary policy to have real effects. An excess supply of labor in rural areas (or informality) pins down the (nominal) wage rate at the margin at some low level. Since wages are a key determinant of non-tradable-goods prices, an increase in the nominal money supply can then raise the relative price of tradables to non-tradables (i.e., depreciate the real exchange rate) and have real effects. The Chinese economy provided a potential illustration until recently, when labor shortages began to produce wage increases.

Whether or not an undervalued real exchange rate is useful for promoting structural change in emerging market economies (a point about which there is no consensus among authors of this report), it has a major disadvantage. An undervalued currency taxes the consumption of tradables (along with

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<sup>26</sup> See Rodrik (2008).