NON-TECHNICAL SUMMARY

There has recently been a revival of interest in equilibrium exchange rates’ assessment due to the current context of global imbalances. Indeed, since the end of the 1990s, the accelerating financial integration process accompanied with the preeminence of capital movements over trade in goods between countries, has engendered a growing disconnection between exchange rate fluctuations and the real economic activity.

In this context, it seems particularly interesting to focus on the impact of currency misalignments on growth since persistent real exchange rate gaps are likely to affect the economic performance of countries. Indeed, persistent misalignments may induce distortions in relative prices of traded over non-traded goods that may be misinterpreted by economic agents and, as a consequence, may generate instability. In addition, the effects may be differentiated in case of an over- or under-valuation of currencies. If the currency is undervalued, competitiveness is reinforced, which stimulates domestic production, investment and exports, and reduces imports. The current account is then improved, so are GDP and employment. Conversely, currency overvaluations are rather interpreted as proofs of incoherent macroeconomic policy decisions, point to an increasing probability of balance of payment crises and of possible currency crashes, and contribute to deteriorate growth.

Our aim in this paper is to investigate the relationship between real exchange rate misalignments and economic growth, by paying a special attention to the potential differentiated effects of overvaluations and undervaluations. To this end, we specifically account for the sign (and the size) of the misalignment by estimating a panel nonlinear model. More specifically we rely on the estimation of a Panel Smooth Transition Regression (PSTR) model, allowing for a differentiated impact of currencies’ overvaluations and undervaluations on economic growth. Moreover, while most of the previous studies consider developing countries, we rely on a wider sample of countries, including both developed and developing economies. Furthermore, we conduct a detailed analysis to derive robust measures of currency misalignments by relying on the Behavioural Equilibrium Exchange Rate (BEER) methodology.
Our results show that the impact of exchange rate misalignments on economic growth depends on their sign: there exists a positive and significant relationship between growth and exchange rate misalignment when the currency is undervalued, whereas overvaluations negatively affect economic growth. This result would imply that undervaluations, which could be attributed to competitive devaluations, may drive the exchange rate to a level that encourages exports and promotes growth.

*J.E.L. Classification:* F31, O47, C23

*Keywords:* growth, exchange rate misalignments, nonlinearity, PSTR models