REAL EXCHANGE RATE MISALIGNMENT AND SECTORAL OUTPUT IN ZIMBABWE

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Abstract
Using the feasible generalised least squares panel data techniques and data for the period 1980 – 2003 from a representative sample of Zimbabwean sectors that include agriculture, manufacturing and mining sectors, the study indicated that real exchange rate misalignment is harmful to sectoral output.. The study indicated instead of undervaluation necessitating sectoral performance it however negatively affects sectoral output while real exchange rate overvaluation as expected, negatively and significantly affects sectoral output.
Key Words: Real Exchange Rate, Sectoral output, Misalignment, Overvaluation, Undervaluation

1. Introduction

Real exchange rate has not been an important variable in growth models and its significance only came following the seminal work of Barro (1994) of including macroeconomic variables in determining growth fundamentals. Real exchange rate signals the performance of the tradable and non - tradable sectors of the economy and provides significant information on the distribution of the scarce resources between the sectors so as to attain sectoral growth and economic growth at large. Movements in the real exchange rate should be in tandem with real fundamentals and if it has persistently wandered away from the long run equilibrium exchange rate, then it will be misaligned. The long run equilibrium exchange rate to which the real exchange rate should gravitate is defined as an exchange rate that is compatible with simultaneous attainment of both external and internal balance. External balance is explained as a sustainable current account position given a country's capital position as a net lender or borrower (Razin 1997) while internal balance implies a situation where the labour and non tradable goods market clears in the current period and is expected to be in equilibrium in the future (Edwards, 1989; Montiel 1999)

Exchange rate misalignments act as indicators on how the exchange rate will have to gravitate in a freely floating exchange rate regime and how authorities need to revalue or devalue their exchange rate in countries employing the fixed exchange rate system. An exchange rate is overvalued if the prevailing exchange rate is below the long run equilibrium exchange rate while the converse holds for an exchange rate undervaluation. Exchange rate misalignment is argued to be an important determinant of economic growth. Overvaluation is presumed to hurt growth whereas the correlation between undervaluation and growth is weak.

In most cases, misalignment has been in the form of overvaluation which hurts the tradable activities, affecting growth performance adversely since productivity improvements tend to be concentrated in export or import competing industries (Dornbusch 1985). Persistent misalignment drove most developing countries and in particular Zimbabwe (through the adoption of Structural adjustment programmes) to put in place proper exchange rate management policies and practices (Munoz, 2006). Contrary to the move towards freely floating exchange rate regimes following the collapse of the Smithsonian agreement, most developing countries and in particular Sub-Saharan African countries are still having conventional fixed exchange rates (Montiel and Hinkle 1999). Sachs (1985) claims that the differences in development experiences in East Asia; Latin America and Africa may be attributed to trade regimes and exchange rate management practices whilst the World Bank (1984) asserts that the unstable and overvalued real exchange rates dwindled the volume of exports and