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Yatsenko V., PhD student in Economics
Taras Shevchenko National University of Kyiv

IMPACT OF AN UNDERVALUED EXCHANGE RATE ON ECONOMIC GROWTH

In the case of growing global instability and vulnerability to external shocks in emerging markets, the analysis of exchange rates remains one of the priority areas of scientific research while state authorities ensure its stability. Moreover, due to market failures, weak institutions, and a high level of openness, the exchange rate is the "second best" tool for improving competitiveness and macroeconomic stability. In particular, many scholars believe that an undervalued exchange rate positively affects economic growth by improving competitiveness, increasing export earnings and facilitating the inflow of foreign investment based on the fundamental laws of international trade and capital flows. However, the empirical verification of the assumption often shows contradictory results. It requires a comprehensive analysis of the mechanisms, tools, potential consequences, and limiting factors of the positive impact of devaluation on economic growth, which is especially important because of the subsequent contraction of the hryvnia as impact of russian war. One of the most common factors for the mixed effects of an undervalued exchange rate is the specifics of each country: its sectoral structure, parameters of aggregate supply and demand, consistency of fiscal and monetary policies, and structural imbalances. The authors propose complementary measures within economic, financial, industrial, and innovation policies that complement and enhance the positive effect of an undervalued national currency on economic growth. In our opinion, such recommendations can be practical to form macroeconomic policy for the post-war recovery in the face of a likely weakening of the hryvnia and growing uncertainty in the future.

Keywords: *exchange rate, undervalued exchange rate, national currency devaluation, economic growth, emerging markets.*

Problem statement. Ensuring of the economic growth and improving the welfare of society are the main goals of the macroeconomic policy of any country in the world. One of the tools to achieve this goal is national currency devaluation, leading to "structural change, investment in new activities, and the acquisition of new productive capabilities" [1], competitiveness improvement, as well as correcting "other macroeconomic imbalances" [2]. However, an undervalued exchange rate's influence on economic processes, particularly growth, remains controversial, especially for emerging markets.

Analysis of the recent publications. Initial research in this area belongs to D. Rodrik, the Harvard Kennedy School professor who stated an undervalued exchange rate's positive impact on developing countries economic growth based on five-year data analysis from 188 countries during 1950-54 and 2000-04. The researcher gave a leading role in stimulating economic growth to the tradable goods sectors. The reason is disproportional suffering from market failures and a non-optimal size in equilibrium. Hence it leads to two adverse effects: a static non-optimal distribution of resources in the economy and a

dynamic lack of investments in traded goods industries compared with the socially optimal level. Professor Rodrik considered a change in the relative price of tradable and non-tradable goods to increase the scale of these sectors, namely transferring abroad, direct subsidies, or real devaluation [1].

Nobel Laureate J. Stiglitz, jointly with M. Guzman and J. Ocampo, argues that the critical approach to achieving economic growth is reallocating resources in favour of industries that generate significant learning externalities. One can use a system of subsidies and taxes as the first best option, which is usually prohibited by international economic law. In this case, the second-best option appears: interventions for exchange rate weakening. It effectively imposes taxes on traded goods industries that create low learning externalities, thus creating an efficient multiple exchange rate system [3]. Combining interventions with other countercyclical measures and industrial policies can effectively accelerate economic growth by eliminating the adverse effects and constraints of the "resource curse" among resource-rich countries. This measure stimulates the development of industries with positive learning externalities to the optimal size and more active use of "social resources" [3].

Among other scientists who have studied theoretical depreciation's impact on economic growth, summarized in table 1, one can note D. Patel and G. Mah [4], S. Mbaye [5], and Z. Ybrayev [6]. A comprehensive analysis of the possible influences and their pro et contra will allow one to form an optimal macroeconomic policy for Ukraine, considering the specifics of the national economy.

Many scientists tested the assumption empirically and found controversial results. For instance, L. Stracca et al. [7] clarified the existence of positive results only for pegged rates and developing countries; K. Shaik and B. R. Gona [11] were in line with theoretical statements, but in a short-run period; B. Tang [13] refuses the direct link between the real exchange rate and growth in the long run. It shows that every case should be explicitly analysed, considering country specifics.

Notion of research unsolved issues. Despite numerous studies and logical assumptions, the positive impact of an undervalued exchange rate on economic growth is not confirmed for many emerging markets, including Ukraine. The hryvnia devaluation in 2008 and 2014 did not lead to the expected improvements in foreign trade and export conditions, attracting foreign investments, adjusting the balance of payments, resolving structural imbalances, and increasing national competitiveness. Moreover, the Ukrainian currency depreciation, contrary to the experience of many countries, caused economic, financial, social and political problems. Likely, the hryvnia devaluation from 28 to 36.5686 UAH/USD, made by the National Bank of Ukraine on July 21, 2022, will not lead to the expected competitiveness improvement of local producers and even could culminate in additional economic consequences in the conditions of a full-scale war.

The purpose of the paper is to study the influence of an underestimated exchange rate on economic growth, identify the causes of negative consequences and develop recommendations for ensuring the economic growth of Ukraine under hryvnia devaluation.

The methodology of the research is based on a systematic approach to economic phenomena and generally scientific methods: comparison (results of related studies,

positive and negative outcomes of devaluation on economic growth, different influence on emerging and developed countries), grouping (effects of an exchange rate from aggregate demand or supply points of view, factors of controversial results, complimentary measures through various policies), generalization (reasons of controversial empirical results, measures supporting positive effects of exchange rate depreciation), synthesis (significant role of exchange rate for developing countries), abstract-logical analysis (possible mechanisms of unevaluated exchange rate impact on economic growth) and identification of a cause-and-effect relationship (the influence of exchange rate on economic growth).

Table 1

An undervalued exchange rate in economic growth

№	Authors	Mechanisms
1	D. Rodrik	mechanism to partially eliminate the disproportional problems in tradable goods industries caused by: – institutional failures: complicate the detailed execution of contracts; – commodity market failures: information and coordination externalities that block structural transformations and economic diversification.
2	M. Guzman, J. A. Ocampo, J. E. Stiglitz	–growth: an industrial policy instrument that emphasizes the diversification of production through the development of high-tech industries and industries that generate learning externalities; –macro stability: using the exchange rate regime as a tool for counter-cyclical regulation and balancing fluctuations in external financing flows and terms of trade.
3	D. Patel, G. Mah	–traditional approach (positive impact): national currency devaluation → ↓ price of domestic goods in foreign currency → ↑ exports and improvement of the trade balance → ↑ aggregate demand → ↑ output and ↑ employment → ↑ economic growth according to the Marshall-Lerner condition; –structuralist approach (negative impact): national currency devaluation → ↑ profit share in GDP → ↓ aggregate demand and ↑ price level → ↓ output and ↓ employment →↓ economic growth, if the propensity of capital owners to save exceeds the propensity of employees' wages.
4	S. Mbaye	–capital accumulation channel: provides for economic growth due to a capital stock increase through the expansion of investment and savings (relatively greater influence) or tradable goods sectors by increasing share in GDP; –total factor productivity growth channel: competitive exchange rate → ↑ prices of tradable goods → ↑ profitability of tradable goods industries → shift of production factors to tradable goods industries with higher productivity → ↑ productivity in the economy → ↑ economic growth.
5	Z. Ybrayev	–the combination of significant international reserves and insignificant foreign savings warns the economy against the destructive impact of external shocks, preventing exchange rate volatility and thus contributing to economic growth; –national currency devaluation increases tradable industries' profitability, especially labour-intensive ones, and their production volumes; hence it promotes weaker foreign exchange restrictions, capital accumulation, the spread of technology and learning externalities, thus contributing to economic growth.

Source: author's summary based on [1, 3, 4, 5, 6]

Research results. Most scientific studies empirically confirm the connection between the exchange rate and economic growth. For instance, based on an analysis of 150 countries during 1970-2010, a 10% change in the exchange rate inversely causes a growth rate change of GDP per capita by 1.5% [7]. A study of the relationship between the real exchange rate and output growth of 166 countries during 1978-2007 proves higher growth rates under a more competitive exchange rate, especially among emerging markets, regardless of the econometric methods used [8]. A 10% decrease of the Bangladeshi taka leads to GDP increase by 3.2% in the long-term and slightly more than 0.5% in the short-term [9]. For the Pakistani economy in 1976-2010, the exchange rate depreciation played a positive role in economic growth by increasing exports, foreign investments inflow, including FDI, and development of import-substituting industries [10]. A significant positive impact on economic growth was found in India based on data analysis during 1990-2017 [11].

However, some studies demonstrate a weak, absent, inverse, or negative relationship between variables. The case of the Republic of South Africa during 1980-2015 proved that the exchange rate does not affect economic growth but depends on its shocks, causing Rwanda to strengthen [4]. In Kazakhstan, during 2009-2019, a fall in the real exchange rate by 1% led to an increase in GDP of only 0.004-0.005 pp. [6]. A study of the Liberian economy during 1980-2015 stated that exchange rate volatility does not affect real GDP in the short and long term, despite significant absolute exchange rate fluctuations [12]. B. Tang refuted the existence of a direct long-term influence of the undervalued yuan on China's economic development from 1994-2012, explaining the country's phenomenal progress through export expansion and foreign capital inflow [13]. Notwithstanding, the last results one can consider contradictory for several reasons. Firstly, despite the invariance of the real exchange rate of the yuan, the author notes the impact of the change in the monetary policy of 2005 on economic growth [13]. Secondly, the indirect effect of the exchange rate on growth through the trade and investment channel does not mean its absence, describing an indirect mechanism. Thirdly, the results can be politically motivated to reduce the pressure by foreign countries to revaluate the yuan.

Scholars find more common points in determining the negative impact of exchange rate volatility on economic growth. An analysis of 13 South African Development Community countries during 2000-2018 demonstrates a deterioration in economic growth due to inflation caused by exchange rate volatility [14]. A sample of 45 countries and emerging markets for 1985-2015 shows a significant negative impact of the volatility of the nominal and real rates [15].

As a result, many scientists believe that any deviation of the exchange rate from the optimal one is destructive for the economy since it leads to macroeconomic disequilibrium [5] (Fig. 1), which is also mentioned in the Washington Consensus [16]. However, some scholars argue that moderate exchange rate volatility can positively impact economic growth [17], while destructive effects cause excessive fluctuations.

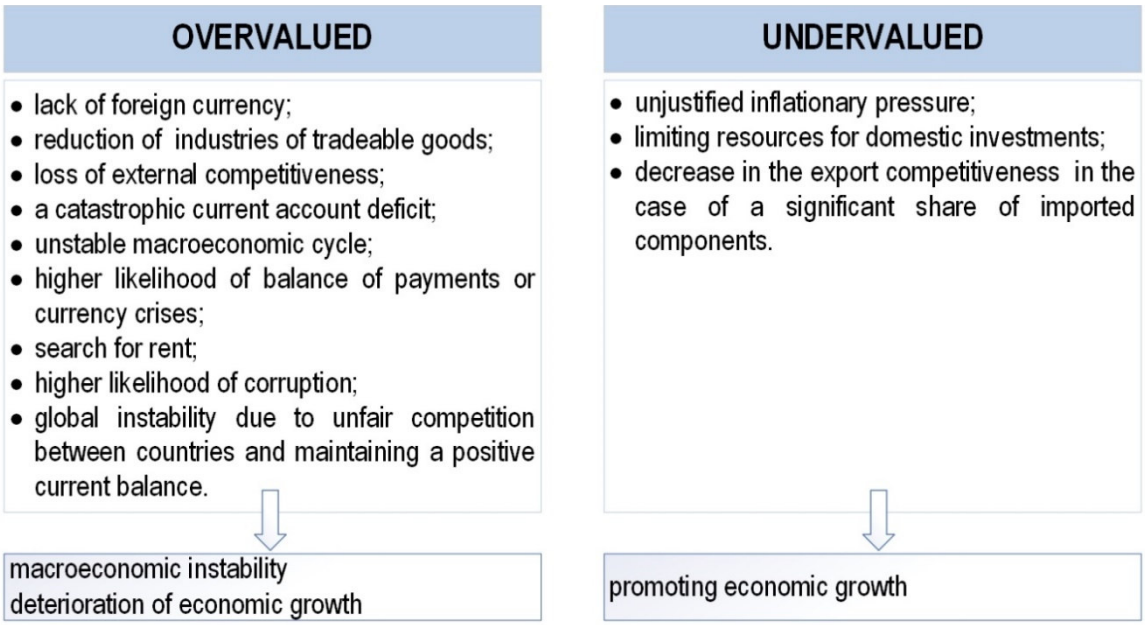


Fig. 1. Disadvantages of the exchange rate deviation from the optimal level
Source: author's analysis based on [1, 16]

The mechanism of the devaluation impact on economic growth also remains controversial; for instance:

– a weak exchange rate can increase savings, investment, and employment by reducing labour costs and redistributing capital from consumers to producers (without affecting the sector of tradable goods) [18] or, in the case of a profit-oriented approach, increase production and employment in both sectors, due to lower wages in the industry of tradable goods [19];

– growth of investment efficiency in tradable industries and structural changes promote economic growth [20];

– private investments growth in tradable goods [16];

– redistribution in favour of non-tradable goods industries that generate significant learning externalities and technological spillovers [21, 22];

– growth in exports, especially in high-productivity industries [23];

– the influence depends on the size of the sectors of tradable goods, especially industrial [1];

– improving the productivity of factors of production [5];

– possibility of diversification and development of high-tech export industries [24];

– growth in exports due to changes in the income elasticity of demand for imports or exports, regardless of the growth rate of world incomes [8];

– the growth of profitability and the ability to self-finance allows the financing of investment projects that generate innovation and technical progress, provide greater product diversity and structural homogeneity between industries [8];

– cut of a balance of payments restrictions as a result of the growth of exports,

which leads to an investment increase [25];

- output growth in the Bertrand competition model and economies of scale [23];
- mobilization of idle labour resources under high official or hidden unemployment [22];
- stimulation of solvent aggregate demand [26];
- eliminate foreign exchange restrictions and prevent a balance of payments crises [27].

Among the reasons for controversial results, one can single out time lags, sectoral structure, compensatory mechanisms, limitations of econometric models, country specifics, and asymmetries (Table 2). In particular, most scientists led by D. Rodrik note a positive relationship between the analysed variables in developing countries and emerging markets [7, 28, 29] and indicate an increase in the effect for poorer countries [1].

Table 2

Factors of controversial results

№	Factors	Action
1	country's economic development	the positive impact of an undervalued currency is true for emerging markets are developing countries; countries' classification matters;
2	exchange rate regime	the fixed regime is used for inflation targeting; the floating regime devotes to achieving growth by improving competitiveness;
3	industry structure	the first gain from a real devaluation is received by low- and medium-tech industries, most of which are labour-intensive; the service sector is more labour-intensive, which means it will potentially benefit more from the exchange rate devaluation; any exchange rate deviation disrupts small resource-rich economies because they have a small undeveloped industrial sector;
4	financial integration level	higher level: balance of payments constraints are levelled by the inflow of foreign capital, indifferent to the exchange rate; lower level: the lack of foreign capital and the limitation of the balance of payments can be leveled by devaluation;
5	policy inconsistency	inconsistency of fiscal and monetary policy can lead to the irrational distribution of resources among industries;
6	the compensation mechanisms	the effect of nominal devaluation can be absorbed by the difference in inflation levels of partner countries, which will not lead to changes in the real exchange rate and hence competitiveness;
7	time lags	in the short term, interindustry relocation of resources can offset price shocks caused by devaluation, which can cause inflation in subsequent periods;
8	model limitation	the result of the study may depend on the chosen period, methodology, and methods used in the data; country classification criteria;
9	asymmetry	the effect of devaluation may exceed the impact of currency revaluation;
10	net effect	the result of the devaluation on economic growth will depend on the excess of the impact on the part of aggregate demand or aggregate supply

Source: author's idea based on[1, 6, 7, 9, 10, 16, 22, 30]

However, according to M. Rapetti, P. Scott, and A. Ramzi, Rodrik's results hide an "interesting non-monotonicity" because of different countries' classifications. If one uses another classification, we can find not only the positive impact of the undervalued

exchange rate on emerging markets but also on the least and most developed countries [22], which completely contradicts the results of [20]. However, it partially confirms the conclusions of P. Van Dai, S. Delpachitra, and S. Cottrell, who have found the sensitivity of newly industrialized countries to exchange rate deviation is lower compared with the transitive economies of East Asia [30].

The exchange rate regime choice is controversial since it leads to different and often mutually exclusive results. For instance, a study of 150 countries based on data from 1970-2010 demonstrated a statistically significant impact of exchange rate changes on real GDP growth per capita for countries with pegged exchange rates [7]. An analysis found a destructive effect on economic growth in the 1960s-1990s in fixed regime countries and moderate or high growth in 1990-2010 in managed floating countries [31]. A study of 45 emerging economies identified the negative impact of volatility in floating regime countries and the lack of connection in countries with fixed exchange rates [15].

Furthermore, according to the Washington Consensus, the role of the exchange rate in economic growth was determined from the supply point of view [32]. However, devaluation also significantly impacts aggregate demand, which can neutralize the positive effects. As a result, all deterrents to the positive impact of a competitive exchange rate can be classified as follows [3, 9, 11]:

– as a destructive factor of aggregate demand: an increase in the prices of tradable goods and, as a result, an increase in the general price level; redistribution of income in favour of people with a higher marginal propensity to save or a lower marginal propensity to consume; demand inelasticity; negative trade balance; different propensity of wages and profits to consume;

– as a deterrent to aggregate supply: higher prices for imported components; pressure on interest rates and a decrease in companies' demand for working capital; growth of government revenues due to devaluation; high prices for raw materials; incomplete information; market imperfection; obligations from international organizations and agreements; high sunk costs; Kaldor-Verdoorn's Law.

For two reasons, the exchange rate cannot be identified as an independent, effective instrument of long-term macroeconomic policy. Firstly, the exchange rate depends on various factors and their impact on economic growth, especially in a floating regime. Secondly, exchange rate volatility is characterized by a dualistic nature. It can play both a positive role (to absorb shocks) and a negative role (to correlate and even predetermine macroeconomic instability) [10, 15]. However, one can effectively use the exchange rate in the early stages of economic formation [7].

Conclusions. Despite conflicting empirical results, the undervalued exchange rate has been a significant growth driver in many developing countries. However, the devaluation success depends on complementary measures that support the exchange rate depreciation and contribute to the positive effects, namely:

– within macroeconomic policy: achieving structural stability; strengthening governmental and market institutions; coordination of fiscal and monetary policy; making simple opening new business; foreign investments attraction;

– within industrial policy: diversification and increase of production efficiency;

expanding the range of traded goods; focus on capital, technology and environmentally intensive industries; increase in export production;

– within innovation policy: investment in education and R&D, improvement of human capital; ensuring accessibility of technologies;

– within monetary policy: countercyclical accumulation of official reserves; ensuring the availability of loans for exporters and small businesses; optimization of public spending;

– within fiscal policy: improved tax conditions for technological industries.

In our opinion, these measures will help mitigate the exit of the Ukrainian economy from the post-war crisis and accelerate economic recovery against the backdrop of a possible weakening of the hryvnia.

We should note that an undervalued exchange rate significantly affects economic growth through improved competitiveness and following export earnings increase, confirmed by the experience of many emerging markets, but Ukraine. Consequently, further studies should include an analysis of the hryvnia devaluation and domestic exports relationship. Identifying shifts in foreign trade and their causes will allow us to partially resolve existing contradictions and more effectively use the advantages of an undervalued exchange rate.

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Яценко В. О., здобувач вищої
освіти ступеня доктора філософії
КНУ імені Тараса Шевченка

ВПЛИВ НЕДООЦІНЕНОГО ВАЛЮТНОГО КУРСУ НА ЕКОНОМІЧНЕ ЗРОСТАННЯ

В умовах зростаючої глобальної нестабільності та уразливості до зовнішніх шоків країн, ринки яких розвиваються, аналіз валютних курсів залишається одним із пріоритетних напрямів наукових досліджень, а забезпечення його стабільності – завданням уповноважених органів державної влади. Крім того, зважаючи на ринкові провали, слабкі інституції та високий рівень відкритості, валютний курс виступає «другим найкращим» інструментом покращення конкурентоспроможності та забезпечення макроекономічної стабільності. Зокрема, на думку багатьох вчених недооцінений валютний курс позитивно впливає на економічне зростання шляхом покращення конкурентоспроможності, збільшення експортних надходжень та сприяння притоку іноземних інвестицій, керуючись фундаментальними закономірностями міжнародної торгівлі та міжнародного руху капіталу. Однак, емпірична перевірка такого припущення часто демонструє суперечливі результати, вимагаючи здійснення комплексного аналізу механізмів, інструментів, потенційних наслідків, нівелюючих факторів позитивного впливу девальвації на економічне зростання, що особливо актуально з огляду чергового падіння гривні. Одним із найбільш розповсюджених факторів негативного впливу недооціненого валютного курсу є специфіка кожної країни: її галузева структура, параметри сукупного попиту та пропозиції, узгодженість фіскальної та монетарної політик, наявні структурні дисбаланси тощо. Враховуючи успішний досвід країн, ринки яких розвиваються та широкий спектр додаткових чинників, авторами запропоновано комплементарні заходи економічної, фінансової, промислової та інноваційної політики, які доповнюють та підсилюють позитивний ефект недооціненої національної валюти на економічне зростання. На нашу думку, такі рекомендації можуть мати практичний характер при формуванні макроекономічної політики післявоєнного відновлення в умовах ймовірного послаблення гривні та зростаючої невизначеності у майбутньому.

Ключові слова: *валютний курс, недооцінений валютний курс, девальвація національної валюти, економічне зростання, країни, ринки яких розвиваються.*