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# Business Cycles, Informal Economy, and Interest Rates in Emerging Countries\*

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## Abstract

This paper recognizes the importance of a large informal economy and interest rate fluctuations for business cycles in emerging countries. I document (1) a positive relationship between the relative volatility of consumption to output and the size of the informal economy, and (2) countercyclical interest rates in emerging countries. I show that in a two-sector real business cycle model of a small open economy with a poorly measured informal sector, an increase in country interest rate generates a contraction in output, consumption, investment, hours, an improvement in trade balance-to-output ratio, and an expansion of informal sector.

*JEL classification:* E26; E32; E43; F32; F41

*Keywords:* Informal Economy; Country Risk; International Business Cycles

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