

Developmental Macroeconomics and New Developmentalism

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1

▶ 1. Structuralist Development Economics (The Pioneers of Development)

2

Structuralist Development Economics

- ▶ It was mainstream from the 1940s to the 1960s
- ▶ Main economists: Rosenstein-Rondan, Ragnar Nurkse, Gunnar Myrdal, Raúl Prebisch, Celso Furtado, Hans Singer, Arthur Lewis and Albert Hirschman
- ▶ Its main sources were the classical political economy (particularly Marx) and Keynesian and Kaleckian macroeconomics.

3

Structuralists adopted the historical-deductive method

(not the hypothetic-deductive method that characterizes the core of neoclassical economics).

SDE generalizes modestly out of past experience, while the neoclassical economists generalize arrogantly out of axioms, thus building ideological castles in the air.

4

Structuralist Development Economics

- ▶ Growth is associated to structural change, i.e., with industrialization.
- ▶ Markets don't lead to industrialization because:
 1. Tendency to the deterioration of terms of trade;
 2. Infant industry argument;
 3. Foreign constraint argument;
- ▶ Thus, a national development strategy (developmentalism) is required.

5

Economic growth implies

1. Education, innovation, good institutions required to increase **productivity**,
2. improving the efficiency of the goods and services in production;
3. transferring labor from industries with low value added per capita to industries with high value added per capita (not just industrialization but **productive sophistication**)
 - ▶ And by increasing the productivity of capital, by the use of more efficient machines that cause increase of the output-capital ratio.

6

A national development strategy (not economic liberalism)

- ▶ A developmental class coalition
- ▶ Economic nationalism
- ▶ Moderate state intervention
- 1. First moment: Import substitution and economic planning;
- 2. Second moment: exports of manufactured goods and industrial policy
- ▶ Accepting moderate inflation due to structural causes for inflation.
- ▶ Growth with foreign savings

7

The theoretical mistakes

1. SDE overestimated the foreign constraint and tried to overcome it by the growth cum foreign savings policy (ignoring that there is a high rate of substitution of foreign for domestic savings).
2. Ignored the Dutch disease and, when was able to neutralize it, did so by intuition.

The policy mistakes (not always)

1. Insisted in import substitution (when it was time for the export of manufactures).
2. Mixed up sustained demand policy with fiscal populism.

8

Structuralist Dev Ec was ousted from the “mainstream” in the 1980s

by the new hegemony of neoliberalism and the neoclassical school.

The neoliberal class coalition formed by rentier capitalists and financiers profited a relatively minor crisis in the United States, in the 1970s, to regain power lost in the Great Depression of the 1930s.

9

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- ▶ 2. New developmentalism, a new school of thought?

10

In the early 2000s, a renewal begins

because the neoliberal consensus failed to promote growth and stability, while it increased inequality.

Landmarks:

UNCTAD (Jan Kregel) and 1997 Asian Crisis Caporale and “Kicking away the ladder” (Ha-Joon (2001/2)

“New developmentalism” (Bresser 2003/2006)

Structuralist development macroeconomics (Bresser 2009).

“Ten Theses on New Developmentalism (80 original subscribers 2010)

11

- ▶ **Developmental Macroeconomics** is the theory
- ▶ **New Developmentalism** is the respective national development strategy
- ▶ A **New Developmental school** of thought will get formed if a sufficient number economist adopt its main theoretical and policy claims.

12

The basic theoretical claims of new developmentalism are

- ▶ First, **growth depends** on investments, which depend on the expected rate of profit, which depends on the exchange rate, the later plays a key role in growth;
- ▶ Second, the **exchange rate** is cyclically and chronically overvalued;
- ▶ Thus, competent firms will not have **access** to markets,
- ▶ except if an **exchange rate policy** neutralizes such tendency.

13

Main policy claims

1. The fundamental challenge that developing countries face is **not industrial policy** but an **exchange rate policy** (besides the monetary and fiscal policies)
 2. The countries that have the Dutch disease must have a **current account surplus**, i.e. foreign dissavings and a net foreign credit (not debt).
- ▶ (For reserve currency countries, a current account deficit is not a problem, provided that they are indebted in their own currencies).

14

New developmentalism (and developmental macro) have in common

1. with structuralist economics to view growth as structural change, and
2. with Keynesian macro that supply does not create demand

But is critical

1. of structuralist economics because views macroeconomic policy, **not industrial policy**, as key to growth;
2. of Keynesian macro because **demand alone does not create investment opportunities** in developing countries: an exchange rate policy is additionally required.

15

Wage-led x export-led is a mistaken alternative

- ▶ It was proposed in a paper by Marglin and Bhaduri (1991), who were concerned with growth and inequality.
- ▶ Their “wage-led” strategy assumed closed trade markets and import substitution.
- ▶ Import tariffs may be a weapon after the infant industry period ended.
- ▶ Import substitution is only legitimate in the very beginning of industrialization.

16

The true choices to make (considering the trade share)

- ▶ **Domestic market-led (trade share falling)**
–only viable together with import substitution (and even then, it did not happen).
- ▶ **Export-led (trade share increasing)**
–required in the transition from an overvalued exchange rate to one fluctuating around the industrial equilibrium.
- ▶ **Balanced (wage share stable)**
–is the **only** consistent with long-term growth.

17

An industrial policy

- ▶ Is always required.
- ▶ But it is a mistake to believe that it dispenses policymakers of having an active macroeconomic policy, including an exchange rate policy.
- ▶ The industrial policies of the past involved the management of the exchange rate – particularly the neutralization of the Dutch disease.

18

▶ 3. The exchange rate

19

For new developmentalism the access to demand is essential

- ▶ Demand is crucial for growth, because investment depends on a satisfactory expected rate of profit, which an effective demand policy would assure it.

But,

in developing countries the **access to demand is crucial**.

▶ And

- ▶ Only a **competitive equilibrium** exchange rate assures such access

20

The exchange rate is key macroeconomic prices

- ▶ Macroeconomic prices: the profit rate, the interest rate, the wage rate, the inflation rate, and the exchange rate.
- ▶ For developmental macroeconomics: the **exchange rate is the more strategic price**, because the rate of profit (and several other economic variables) depends on it.
(The exchange rate is a **light-switch** that connects, or disconnects competent business firms from demand).

21

Yet, the exchange rate is the macro price that economics studies less

- ▶ Up to the 1980s it was limited to international economics (macroeconomics was a closed discipline)
- ▶ Since then macroeconomics began to take into account; not development economics.
- ▶ In WTO and in the World Bank the exchange rate is **forbidden**. Recently the US pressed UNCTAD to stop dealing with it, and Brazil had to intervene to avoid such prohibition.

22

The exchange rate – the current account nexus is direct

- ▶ A higher current account deficit implies a more appreciated currency.
- ▶ The causal relation is in the two directions:
- ▶ The decision to incur in current account deficit (foreign savings policy) appreciates the currency.
- ▶ Policies directly appreciating the currency imply increased current account deficit.

23

Arguments that neoclassical economists use to corner the exchange rate?

1. They say that is impossible to manage it.
 2. They understand that who tries to have an exchange rate policy is a "mercantilist".
 3. They argue with the **triangle of impossibilities** that if you want a monetary policy and capital mobility you have to give up the fix regime (i.e., exchange rate policy).
 - ▶ But,
1. countries don't need to choose sharply between monetary policy, exchange rate policy and capital mobility.
 2. If they have to choose, the variable that should be sacrificed is not exchange rate policy but capital mobility

24

Actually orthodox economists

- ▶ see it as a dangerous price due to the experience of competitive devaluations;
- ▶ know that an overvalued exchange rates improve exports of rich countries; and
- ▶ Are happy because current account deficits **legitimate** foreign loans and particularly the direct investments, which are the key tool that they use to **occupy** without reciprocity the domestic markets of developing countries.

25

Keynesian and structuralist economists also disregard the exchange rate

Because they assume that the disequilibrium of the exchange rate is a **short-term** problem, a problem of “misalignments” and “volatility”.

Whereas developmental macroeconomics sees the exchange rate as overvalued in the long-term, chronically, and puts it in the core of its theoretical system.

26

Does this means that the other macro prices are not relevant?

- ▶ No, but the profit, the wage and the inflation rate depend of it.

So, why I will not discuss these other prices?

- ▶ Because they are less strategic;
- ▶ And because I don't have much to add to the macroeconomics of the interest, the inflation and the wage rate, while I have to add on the exchange rate.

27

Doubly effective exchange rate

- ▶ Note that I am speaking of an effective exchange rate: one that is based on a currency basket (effective) and that considers tariffs and subsidies (effective-effective). And I am only interested in the real exchange rate.

28

4. The tendency to the cyclical and chronic overvaluation of the exchange rate

29

The four tendencies limiting investment and growth

1. The short-term Keynesian chronic insufficiency of demand
 2. The long-term tendency of wages to grow below the productivity rate
 3. The tendency to the overvaluation of the exchange rate
 4. Tendency to the insufficiency of public savings limiting public investments
- I will discuss only the third one.

30

Causes of the cyclical and chronic overvaluation

- ▶ Structural
 1. The Dutch disease
 2. The profit and the interest rate are higher in developing countries (minor cause)
- ▶ Policy causes
 1. Growth cum foreign savings policy
 2. Use of the exchange as an anchor against inflation
 3. Exchange rate populism

31

▶ 4.1. The Dutch disease

32

Concept of Dutch disease

- The Dutch disease or natural resources' curse is
- ▶ the lasting over-appreciation of the national currency
 - ▶ caused by abundant and cheap resources that originate Ricardian rents and, for that reason,
 - ▶ exports of the respective commodities are viable with an exchange rate substantially more appreciated than the one required to make economically viable tradable industries using world state-of-the-art technology.

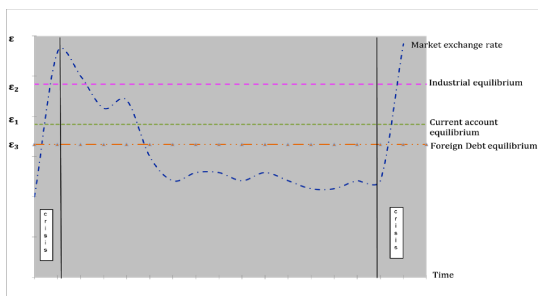
33

Three equilibrium exchange rates

- ▶ When the Dutch disease is present we have to exchange rate equilibriums:
 - ▶ "Current equilibrium"
 - ▶ ϵ_c
 - ▶ "Industrial equilibrium"
 - ▶ ϵ_i
 - ▶ "Foreign debt equilibrium"
 - ▶ ϵ_f

34

Current, industrial, and foreign debt equilibrium and the market exchange rate.



Which of these three equilibriums is the real one?

- ▶ It is not either the
 1. the "current equilibrium" (the one that intertemporally balances the current account).
 2. or the "foreign debt equilibrium", that keeps the foreign debt/GDP ratio constant.
- ▶ It is the **industrial equilibrium** (the one that makes competitive business firms using technology in the world state-of-the-art).

36

The DD is a long-term market failure

- ▶ The Dutch disease is a major market failure because it turns not viable other existing and potential tradable industries using technology in the state of the art.
- ▶ Given the fact it is consistent with current account equilibrium: the market does not correct such failure even in the long-term.

37

Who gets the Ricardian rents

- ▶ When it is not neutralized and the country is reasonably developed, all consumers;
- ▶ When it is not neutralized and the country is poor, the oligarchy that exploits the commodity and foreign interests.
- ▶ When it is neutralized, directly, the state, indirectly, the whole population
 1. due not so much the use of the rents by the government,
 2. But due to the faster growth of the country.

38

The current account

- ▶ Is the exchange rate that balances intertemporally the current account.
- ▶ In a country with Dutch disease is the cost + reasonable profit of the exporters of the commodity originating the Dutch disease.
- ▶ Which is determined by the evolution unit labor cost of the country in comparison with a the unit labor costs of basket of currencies.
- ▶ The exchange rate price will float around the current equilibrium.

39

The industrial equilibrium

- ▶ Is the value of the exchange rate that covers the cost plus reasonable profit of the non-commodity firms producing tradable goods in a country.

The foreign debt equilibrium

- ▶ Is the value of the exchange rate that produces a current account deficit consistent with a moderate constant foreign debt ratio.
- ▶ It is the **conventional** exchange rate equilibrium.

40

The Ricardian rents

- ▶ Are the difference (per dollar) of the international price of the commodity (which I suppose to be equal to the cost+reasonable profit of the last firm admitted in world market of the commodity) and the cost+reasonable profit of producing the commodity in a given country.

41

of the Dutch disease, g

- g is the relation to the industrial equilibrium of**
 - ▶ the Ricardian rents per dollar (r)
 - ▶ or the difference between the industrial equilibrium and cost+reasonable profit per dollar of the commodity originating the disease) in :

$$g = r / \epsilon_i$$

$$g = (\epsilon_i - \epsilon_c) / \epsilon_i$$

42

Example: three countries and three commodities

(national currency (#) per dollar)

	1	2	3=1-2	4=3/1
Country	Industrial Equilibrium	Commodity Cost+profit	Ricardian rents (DD)	
A	# _A 2.00	# _A 2.00	# _A 0	-
B	# _B 3.00	# _B 2.20	# _B 0.80	26.6%
C	# _C 5.00	# _C 1.00	# _C 4.00	80.0%

Observe that the cost+reasonable profit of the commodity corresponds to the current equilibrium.

43

Symptoms of the Dutch disease

- ▶ In poor countries: No industrialization in countries exploring natural resources.
- ▶ In middle income countries: Desindustrialization and “maquilization”

44

The Dutch disease is damage?

- ▶ Neoclassical economists reject that the non-viability of manufacturing industry is a disease.
- ▶ For structuralists it is a major evil, because it turns not viable
 1. Not only present
 2. But potential productive sophistication.

45

Amplified concept

- ▶ Cheap labor is also origin of Dutch disease provided that the wage span (difference between engineers' salaries and workers' wages) is substantially higher than in high wage (rich) countries.
- ▶ In this case, the exchange rate will be determined by the goods using cheaper labor, and the more sophisticated industries will turn economically unviable.

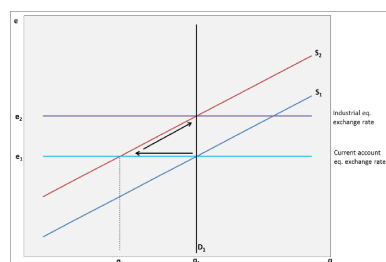
46

Neutralization

- ▶ A tax on sales and exports that move up the supply curve of the commodity in relation to the exchange to the level where tradable industries' average market price will be equal to the necessary price.
- ▶ Establishment of an international fund to avoid currency appreciation.
- ▶ Possible creation of a stabilization fund for the commodities originating the disease.

47

Neutralization of the DD with an export tax



48

The tax rate

- ▶ Should be equal to the severity of the disease as defined above.
- ▶ Should capture the rent, leaving some margin for the commodity exporters (in dubio, for the commodity exporter).
- ▶ Should be variable, depending principally on the changes in international prices.

49

Example of neutralization with an export tax

- ▶ Assume, for instance, that the industrial equilibrium is R\$ 3.0 per dollar and the current equilibrium, R\$ 2.20 per dollar.
- ▶ If the effective exchange rate is in current equilibrium, because it is not being depreciated further by excessive capital inflows, a tax of R\$ 0.80 per dollar will move the exchange rate to R\$ 3.00 per dollar.

50

Example of neutralization with "industrial policy" (a disguised tax, Brazil 1970s)

- ▶ Import taxes - 50%
- ▶ Export subsidies - 50% (manufactured goods)
- ▶ Commodities: no subsidy
- ▶ Market exchange rate: #20.00 per dollar
- ▶ Exch rate for manuf goods: #30.00
- ▶ Exch rate for imported goods: #30.00
- ▶ Disguised tax: #10.00 = 33%

51

A sovereign fund does not neutralize the DD

- ▶ A country as Norway uses its sovereign fund to not internalize immediately the tax revenues, thus not increasing capital inflows.
- ▶ If the country decides to internalize and expend such revenues, the DD will continue neutralized, but the government will have to limit other capital inflows so as not to appreciate the currency.

52

Difficulties in neutralizing

- ▶ Transitory rise of inflation
Problems to firms indebted in dollars
- ▶ Transitory wage reduction
- ▶ Commodity exporters' fear that the tax is not just marginal, and they will not bear costs.

53

▶ 4.2. The policy causes
of
overvaluation of exchange rate

54

Policy causes

1. Growth cum foreign savings policy
2. Use of the exchange as an anchor against inflation
3. Exchange rate populism

55

a. The foreign savings policy is a mistaken policy

- ▶ It assumes that foreign savings (current account deficit) increases indebtedness in foreign currency but adds to domestic savings.
- ▶ It is implemented with
 1. High interest rates to implement such policy.
 2. Facilities to foreign direct investments
- ▶ It is justified with the existence of a major "foreign constraint".

56

The "foreign constraint" thesis

The 1950s structuralist observed shortage of dollars.
They explained it with the two income elasticities..
The two gaps model was its formalization.
The **policy inference** was the foreign savings policy.
The Thirlwall law (that exports are the limit for growth) legitimated the foreign savings policy.

57

The foreign constraint issue was highly overestimated

- ▶ First, because the elasticity of imports to income tends to fall as developing countries industrialize.
 - ▶ Second, because the cause of the dollar shortage was the two elasticities, but the chronic overvaluation of the exchange rate.
- Yet,
- ▶ until today the foreign constraint remains a legitimation for foreign indebtedness,
 - ▶ and is an inexhaustible source of post Keynesian papers...

58

Currency crises begin with the foreign savings policy, which

1. Involves a **high rate of substitution (around 50%)** of foreign for domestic savings;
2. Causes financial fragility and the dismay "confidence building" policy; and
3. Ends up into currency crisis (sudden stop).

59

Foreign savings policy don't add to domestic savings

- ▶ Because **the decision** to incur into current account deficit **appreciates** the national money, what,
 1. **On the demand side**, it reduces the investment opportunities, and the potential investments don't materialize;
 2. **On the income or supply side**, it increases wages and consumption, open room for foreign savings substitute domestic savings.

60

The rate of substitution (dS_i/dS_x) is usually high (around 50%)

1. Due to the high elasticity of the exchange rate to the current account deficit;
2. Due to the elasticity of wages and other revenues to the exchange rate; and
3. Due to the high propensity to consume out of wages and other revenues.

61

When the rate of substitution is small and the foreign savings policy is sound

- ▶ When the country is growing very fast,
- ▶ so that the expected profit rates is high, and,
- ▶ so, the marginal tendency to consume falls.

I believe that the last time that this happened in Brazil was in the 1978–1973 “miracle”.

Don't confuse this with the fact that in the very short term, the depreciation slows growth because revenues fall and the increase in investment rate still didn't happen.

62

We can have the inverse (substitution of domestic for foreign savings)

- ▶ when foreign savings change into foreign di-savings,
 - ▶ when foreign di-savings rise,
- and also

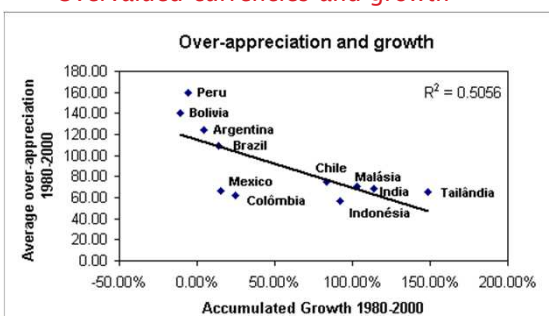
63

Empirical evidence supports growth with domestic savings

- ▶ All countries always developed using essentially domestic savings
- ▶ Developing countries tend to face negative capital outflows
- ▶ We cannot find correlation between foreign savings (current account deficits) and growth
- ▶ We also cannot find correlation between FDI and growth
- ▶ The Feldstein–Horioka “puzzle” also did not support the GFSP: investment is financed by domestic savings

64

Overvalued currencies and growth



65

b. Exchange rate anchor policy

- ▶ The exchange rate is often perversely used as a means to control inflation.
- ▶ In principle, orthodox policy leaves this job to the interest rate (what is OK if the variation is not confused with the level of the interest rate, and if this instrument is combined with others).
- ▶ But, in practice, inflation targeting policy uses often an exchange rate anchor to control inflation.

66

c. Exchange rate populism

- ▶ It was always the tool of politicians with poor republican spirit (besides fiscal populism).
- ▶ Recently it also turned into an argument of orthodox economists in Brazil, because:
 - ▶ 1. they reject a policy of competitive exchange rate in the industrial equilibrium level (which they call "depreciated") because it would be "injust to the poor"...
 - ▶ 2. They defend current account deficits because they "help to increase the consumption of the poor".

67

5. The closing of the system: the currency crisis

68

Currency crisis

- ▶ **The Dutch disease** pulls the exchange rate to the current equilibrium
- The other causes**
- ▶ Pull it down, making the exchange rate to fall below the foreign debt equilibrium, stays there for a time, foreign creditors lose confidence, and we have a currency crisis.

69

Two major types of financial crises

- ▶ Banking crisis (typical of rich countries)
- ▶ Balance of payment crises, or currency crisis (typical of developing countries),

They are worse than banking crises because, as they are contracted in foreign money (money that you cannot issue), they involve sovereign default and dependency.

70

Why the floating regime

- ▶ doesn't **prevent** the exchange rate to remain chronically overvalued?
- ▶ Because the growth with foreign policy and exchange rate populism concur to form a **credit bubble**.

71

Thus, if the country does not have an effective exchange rate policy

- ▶ The exchange rate will not fluctuate nicely around the current equilibrium, as conventional economists predicts
- ▶ Nor it will fluctuate volatility around the current equilibrium as Keynesians predict
- ▶ But the economy will go from currency crisis to currency crisis, from sudden stop to sudden stop.

72

An exchange rate policy is effective

- ▶ When the country has Dutch disease, if the country presents a current account surpluses.
 - ▶ It is true that
- ▶ in the moments of high growth the rate of substitution falls and equilibrium or even a small current account deficit will work well.
- ▶ These are rare moments.
- ▶ An industrial policy is not a substitute for an exchange rate policy.

73

How much foreign capital a country needs

- ▶ **None** (if it suffers the DD)
Nurkse: "capital is made at home".
- ▶ **But**
- ▶ foreign direct investments are not just an occupation of domestic markets without reciprocity when:
 1. They bring effectively technology;
 2. They are export oriented.

74

This Developmental Macroeconomics is a base for a new developmental school of thought?

Only when heterodox economists give priority to **an exchange rate policy** in relation to all other growth policies.
For sure, making trade-offs with income distribution and protection of the environment.

75

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76

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77