Greenwich Political Economy Research Centre

GPERC

Dutch disease-cum-financialization and external balance cycles in developing countries

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Outline of the presentation

1. **The economic context**

2. **Aim of the paper**

3. **The model**

   3.a Medium-run BoP cycles in developing countries

   3.b Long-run composite effects on economic development

4. **Policy proposals**

1. The economic context

Inductive approach based on the most recent Colombian development pattern – the "locomotora minero-energetica" (Botta, Godin, and Missaglia, 2016):

1. Huge FDI targeting domestic natural resources since mid 2000s
2. Strong nominal (and hence real) appreciation of the Colombian pesos
3. Financial euphoria: huge portfolio capital inflows and further appreciation
4. De-industrialization and increased dependence on the "mining-energy sector"
5. Increasing foreign capital-financed current account imbalances

Is this development pattern sustainable?

2. Aim of the paper

What's new from the point of view of economic theory

1. Monetary aspects of Dutch disease: *nominal* exchange rate determination and implications for external balance dynamics

2. Theoretical merge between long-run dynamics (Dutch disease, permanent RER appreciation and de-industrialization) and medium-run cycles (heightened macroeconomic instability)

3. Description of a complex Dutch disease-cum-financialization phenomenon

3. The model/1

Theoretical Framework:

1. Small resource-abundant developing country attracting natural resource-oriented FDI
2. Liberalized trade and financial accounts
3. Inflation targeting monetary policy, i.e. flexible exchange rate regime

Assumptions:

1. FDI concentrates in the natural resource sector
2. Portfolio investment consists of short/medium-term foreign currency-denominated bonds

3. The model/2

Differential equations and economic dynamics

1. Exchange rate dynamics linked to deficits/surpluses in the BoP:

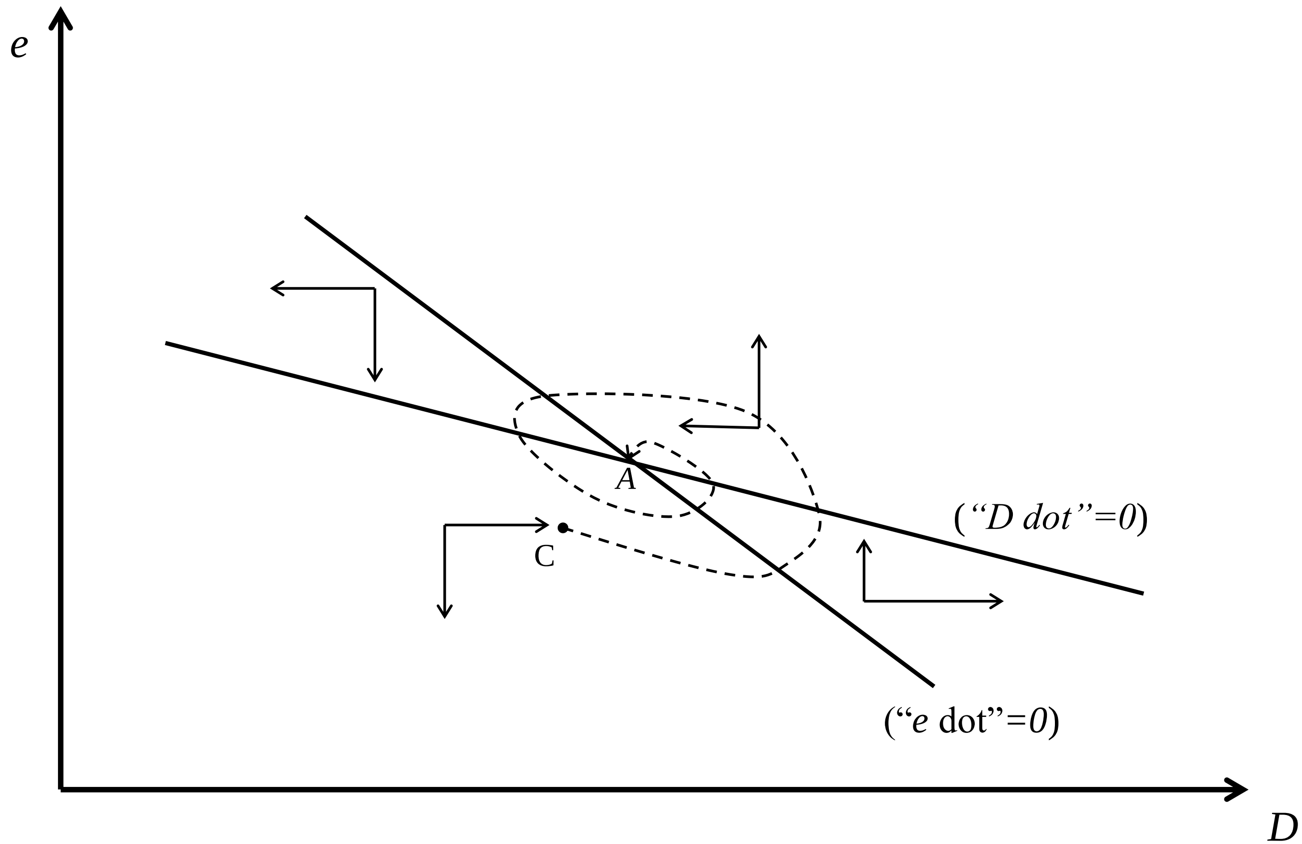
$$\dot{e} = e\left\{\left[imp_M(e) - \frac{exp_M(e)}{e}\right] - exp_{NR} + i_H D + \pi_{NR} + \dot{R} - KA_{PI}\left(i_H - i_F - \sigma(e, D)\right) - KA_{FDI}(N)\right\}$$

2. External debt dynamics linked to portfolio investment:

$$\dot{D} = KA_{PI}\left(i_H - i_F - \sigma(e, D)\right)$$

3. The model/3

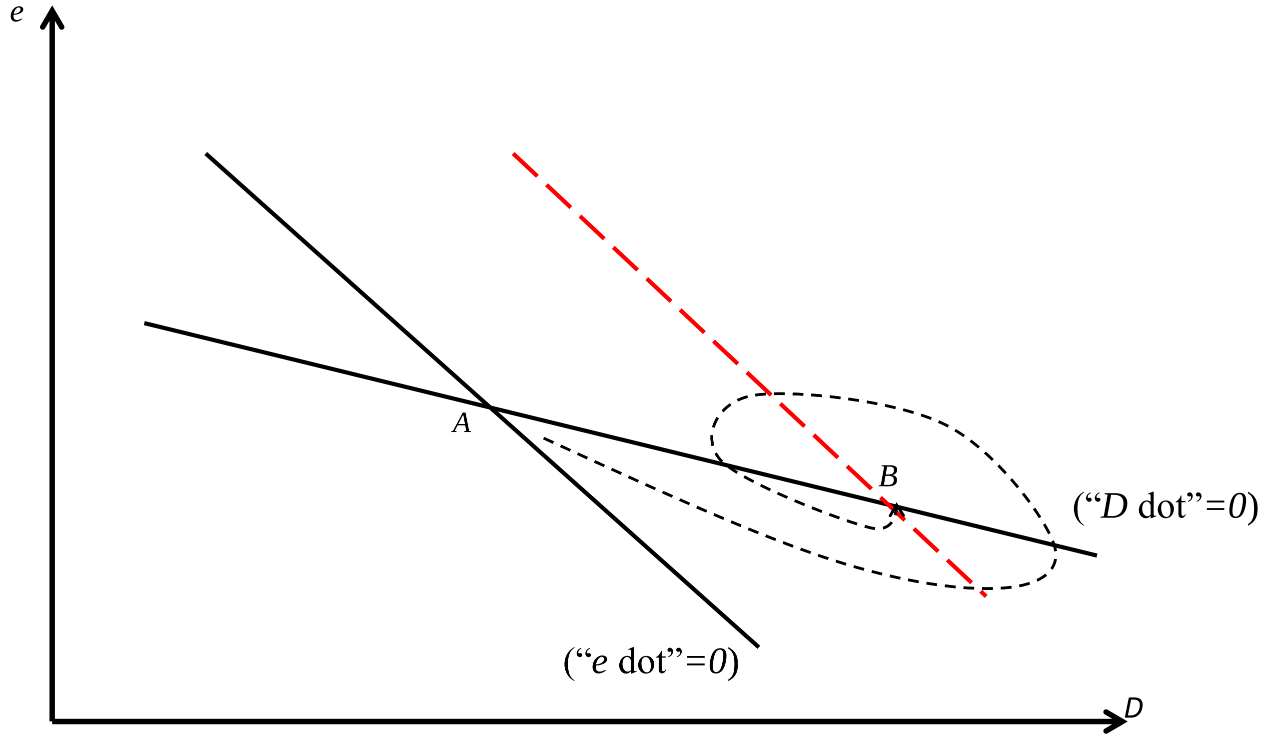
Possible cyclical dynamics in the (*e*-*D*) space:



3. The model/4

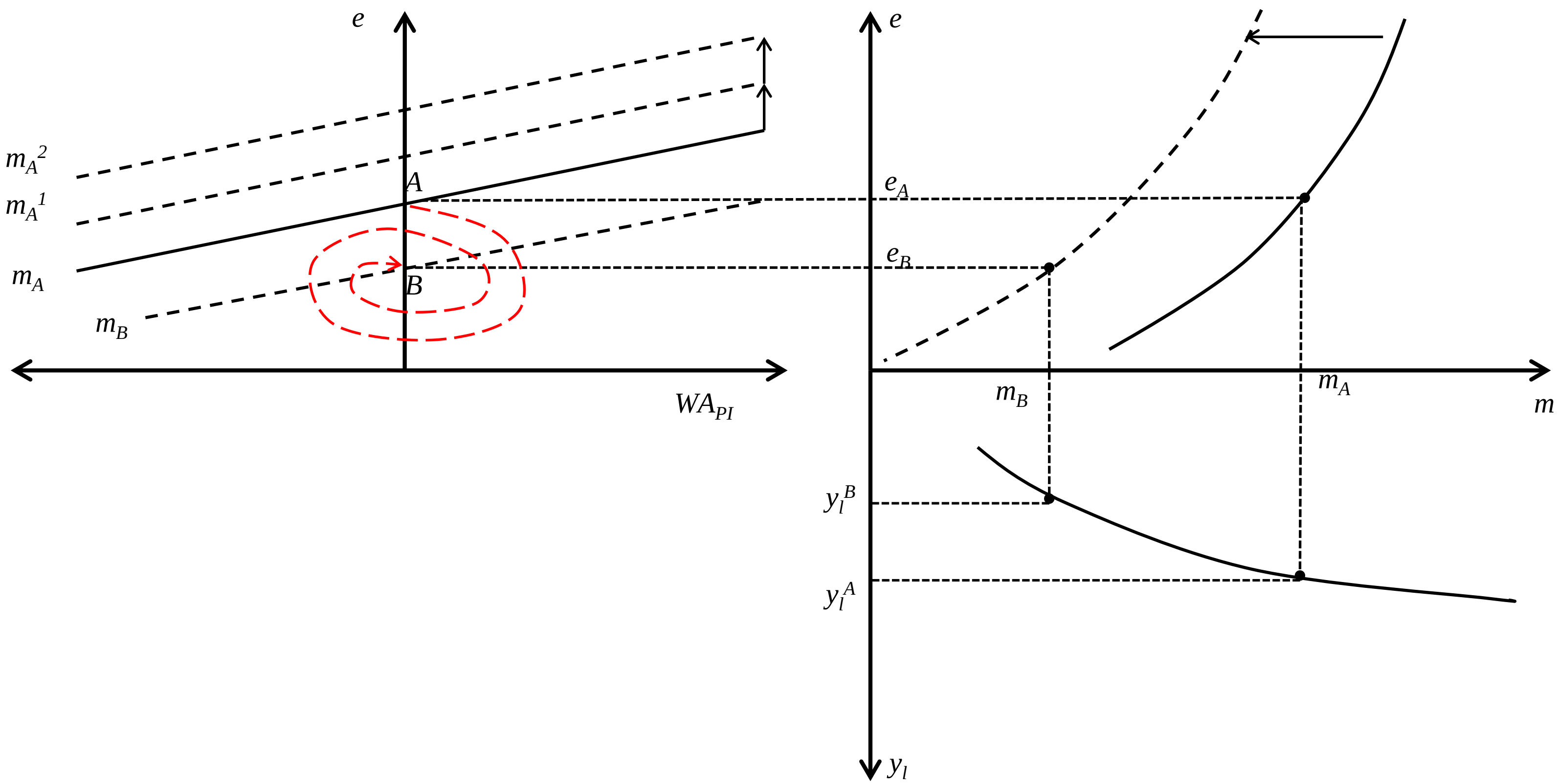
Initial surge in natural resource-oriented FDI

Medium-run macroeconomic outcome: exchange rate volatility, capital reversals and macroeconomic instability



3. The model/5

Long-run development: Premature de-industrialization + permanent slowdown in the labor productivity growth rate



4. Policy Proposals/1

Orthodox OECD-type prescriptions for Colombia given market-determined nominal exchange rate + free trade and capital movements:

1. Counter-cyclical policies: restrictive fiscal and monetary stances in period of economic bonanza to curb possible RER appreciation

2. Reduction of labour costs: eliminate high minimum wage standards and extensive deregulation of labour market

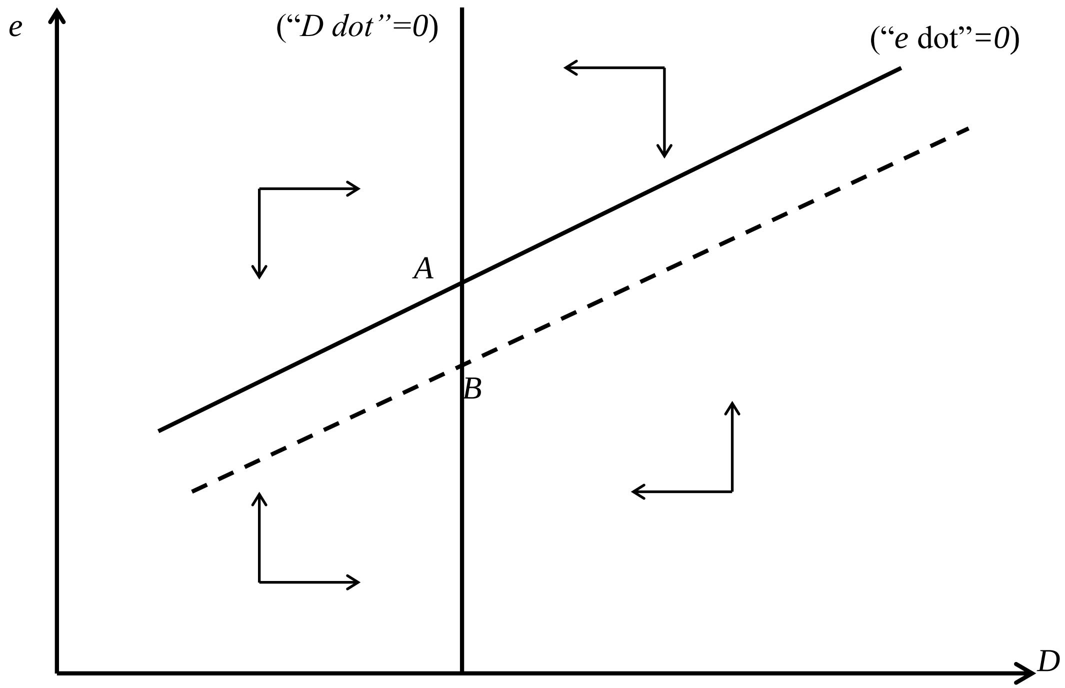
3. Public investments: in infrastructure to increase TFP (and maintain RER competitive)

4. Productive and export diversification: Through *horizontal* industrial policy

4. Policy Proposals/2

Heterodox alternative/1

1. Tight capital controls: de-link exchange rate dynamics from capital flows and avoid macroeconomic instability



4. Policy Proposals/3

Heterodox alternative/2

2. Active management of nominal exchange rate by CB on currency market: keep nominal and RER depreciated by accumulating foreign reserves

   2.1. Managed exchange rate to be preferred to both pegged (in the 90s) and fully flexible exchange rates (in the 2000s)

   2.2. Developmentalist monetary policy: competitive-constant RER rather than ‘pure’ inflation targeting

3. Policy coordination: Inflation control through monetary-fiscal-social policy coordination

4. Active industrial policy funded with windfall revenues and based on dynamic comparative advantages

Thank You

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