Developmental macroeconomics and new developmentalism

Presentation at the special section on this theme, Post Keynesian Conference, Bilbao, May 2016.

Luiz Carlos Bresser-Pereira
www.bresserpereira.org.br

Two meanings of the word "developmentalism"

A really existing form of state and of capitalism alternative to economic liberalism

- Ex: Mercantilism, Bismarckism, Golden Years Capitalism, National-developmentalism, Developmentalism social
- Def: moderate state intervention, economic nationalism, developmental class coalition

A theory

Classical developmentalism (1940s-1960s)
New developmentalism (from 2000s…)

I – NEW DEVELOPMENTALISM

- It is formed of

1. New-developmental macroeconomics
2. New-developmental political economy
3. New developmental microeconomics (just a draft)

- It is oriented to middle-income countries, whose key difference in relation to the richer, besides the level of income per capita, is that they get indebted in foreign money.
- It is focused in the current-account deficit and in the exchange rate.

ND adopts the historical-deductive method

- ND adopts the historical-deductive method of Smith, Marx and Keynes.
- It rejects the hypothetical-deductive method, which is valid for methodological sciences as econometrics and economic decision making theory, not for a social science as economics is.
- Yet, it accepts some theorems – logical constructs like the law of comparative advantages, or the Balassa-Samuelson effect.
- But just as logical relationships, not as generalization of habitual behaviour. That is what do historical models
- From theorems one does not derivate policy. To do that is to fall into Schumpeter's "Ricardian vice".
- Policy must de derivate from historical models.
- The historical models don't lead to certitudes, but to things that happen "generally", "probably".

New developmentalism is a response to inconformity & unsatisfaction

- Inconformity with the deindustrialization and low rates of growth of Brazil (and Latin America) since

1. The 1980's Foreign Debt Crisis
2. Trade and financial liberalization from 1990.

while East Asian countries continued to grow fast

- Unsatisfaction with the explanations offered by the two schools of thought I was formed –

1. Post-Keynesian macroeconomics, and insufficiency of demand explanation
2. Classical developmentalism and the lack of industrial policy explanation.

New developmentalism originates from two historic economic theories

- Classical Developmentalism (Nurkse, Lewis, Prebisch, Furtado), which

1. Lacks a macroeconomics
2. Defends protectionism

- Post-Keynesian Macroeconomics. in some cases, together with Classical Developmentalism

1. Aren't adapted to middle-income countries
2. Sponsor growth with foreign savings
3. Don't have a theory on the exchange rate
4. Don't have a model of Dutch disease
5. Don't have a proposal of exchange rate policy
6. Don't propose an export-led strategy
7. Don't have a theory for currency crises.

ND's political objectives

- The same objectives that modern societies defined historically:

1. Security, national autonomy, social order
2. Individual freedom, democracy
3. Growth with price and financial stability, increasing investment and limiting indebtedness.
4. Social justice – reducubg inequalities
5. Protection of the environment.

ND's political economy

- Developmental states tend to be more efficient than liberal countries.
- A developmental state is defined by

1. priority to growth;
2. a developmental class coalition, where productive capitalists play a key role, and rentier and financiers form the liberal opposition;
3. moderate state intervention;
4. economic nationalism.

ND rejects fiscal populism and/or exchange rate populism

- Economic populism is to expend irresponsibly more than it gets:

1. Fiscal populism: the state incurs in high and chronic budget deficits (usual for vulgar Keynesians);
2. Exchange rate populism: the nation–state incurs in high current account deficits (almost inevitable for liberals; usual for developmental policymakers.

The state's main mission in middle-income countries

- Is not to protect infant industries (middle-income countries overcome this phase). .
- Is to guarantee the general conditions making <u>competitive</u> the competent firms
- by guaranteeing property rights and contracts
- by assuring a good infrastructure
- by keeping the macroeconomic prices right,
- principally by keeping the exchange rate competitive.

The challenge facing social-democratic new developmentalists

- Is not trivial.
- Is to combine developmentalism with social-democracy and the protection of the environment.
- Is to govern capitalism more compently than capitalists,
- i.e., making consistent growth with stability, reduction of inequalities, and respect to the environment, which is a public good.

II – ND’s MACROECONOMICS

1. There are five macroeconomic that the market is unable to keep right.
2. The investment function, and growth depending on investment and technological progress.
3. Determinants of the exchange rate price: the value and the demand and supply of foreign money.
4. There is a tendency to the cyclical and chronic (long-term) overvaluation of the exchange rate.
5. Causes of the tendency: The Dutch disease and the three habitual policies
6. There is a inverse relation between the exchange rate and the current account. Thus, foreign savings replace domestic savings, rather than get added.
7. Recurrent financial crises
8. Financialization

1. The five "right" macroeconomic prices

Quite different from neoclassical "right prices".

PRICES	THEY ARE RIGHT WHEN
Profit rate	Should be satisfying, sufficient to make business firms to invest
Exchange rate	Should make competitive competent firms existing and potential
Interest rate	Should be set at a low level, around which to conduct monetary policy
Wages	Should be consistent with a satisfying profit rate (growing with productivity)
Inflation	Should be below two digits.

"Satisfying"– Herbert Simonb

2. The investment function
(on what depends the investment rate)

- Classical school: it depends on the expected profit rate and the interest rate;

- Keynes: OK, but the expected profit rate depend on demand, which is not assured by the market.

- New developmentalism: OK, but the expected rate of profit depends also on the access to demand, which is not assured when the tendency to the overvaluation of the exchange rate is not neutralized.

3. Determinants of the exchange rate and the tendency to overvaluation

- The exchange rate depends on its value or current equilibrium, and the demand and supply of foreign money, which make the ER to float around the value/
- The value or current equilibrium depends
1. on the comparative unit labor cost index CULCI
2. and the terms of trade.
- The demand & supply of foreign money depends
1. on three habitual policies and
2. on text-book variables.

3.1. A value of the exchange rate

- The price of the foreign money floats around the value according to the demand and supply of foreign money.
- The value of the exchange rate is the current equilibrium – is the value that cover the cost plus reasonable profit of the tradable firms that participate from the international trade and assure the equilibrium of the current account.
- In the case of Dutch disease, the exchange rate continues to be determined by the current equilibrium, which depends on the commodities
- And we have a second value, the industrial equilibrium, relative to the non–commodity tradable goods.

The value of the exchange rate depends on

- On changes in the comparative unit labor cost index (CULCI), which affects directly the cost of production and indirectly the current account.

1. ULC – wages / productivity
2. CULCI – compares the local ULC with a basket of ULCs of competing countries.

- Changes in the terms of trade, which affect directly the current account.

When the value or the current eq goes up, the ER depreciates

1. When CULCI goes up, and/or
2. When the terms of trade goes down

- the value increases and the exchange rate price depreciates

1. because the ER must depreciate to keep competitive the the firms and balanced the current account.

- This was what happened in Brazil recently (2014-15): the huge depreciation was caused by wages increasing more than productivity and, mainly, because the prices of the commodities fell sharply

3.2-The price of the ER and the three habitual policies

- Besides depending on the value, the ER depends on the demand and supply of foreign money, which depends on:
- Three habitual (equivocated) policies

1. Growth with foreign savings (c-a deficits)
2. Exchange rate anchor against inflation
3. High level of the interest rate

- Text-book variables: effective demand capital inflows and outflows, confidence, existence or not of capital controls, etc..

4. Historical tendencies in historic theories

- Classical school: tendency to the falling rate of profit.
- Keynes: tendency to the insufficiency of demand.
- Classical developmentalism: tendency to the deterioration of term of change.
- New-developmentalism: tendency to o the cyclical and chronic (long-term) appreciation of the exchange rate.
- (Neoclassical economics does not have a tendency because it is not historical.)

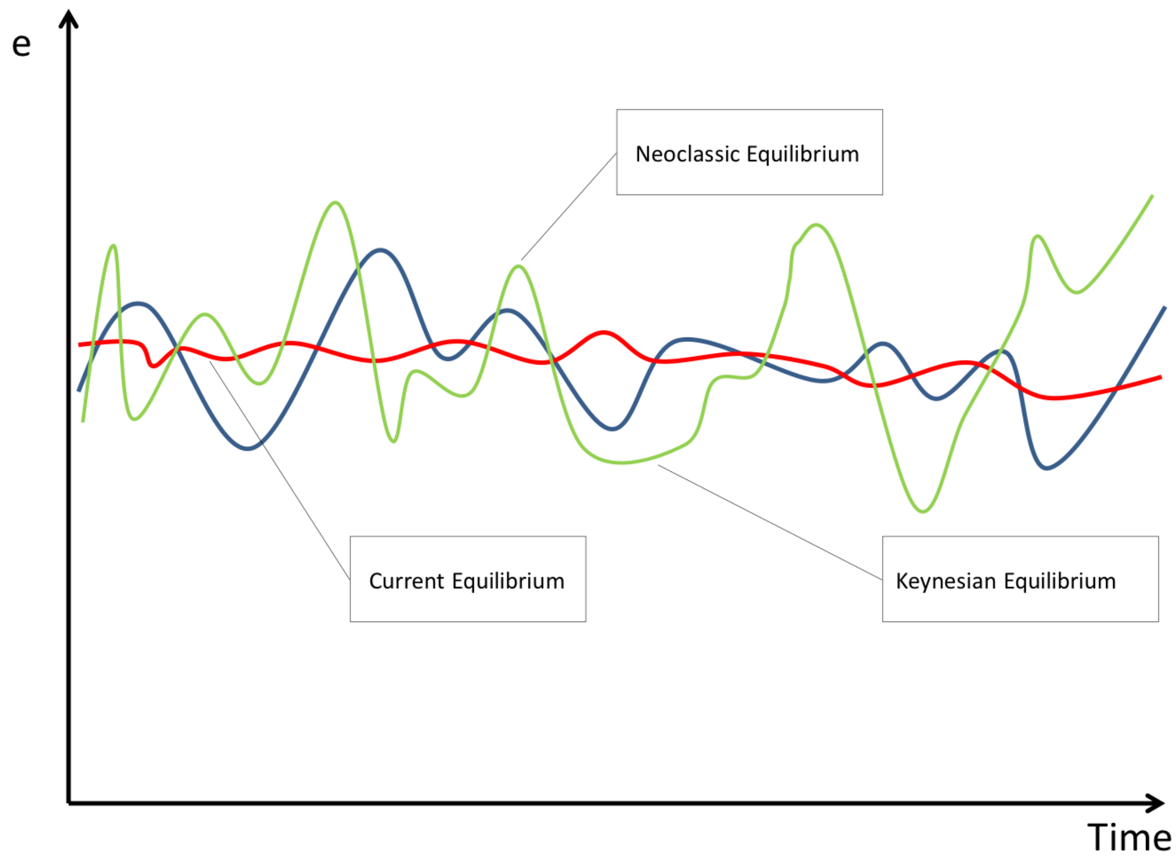
Caveat: don't mix the tendency with volatility

- Neoclassical school – smal misalignments

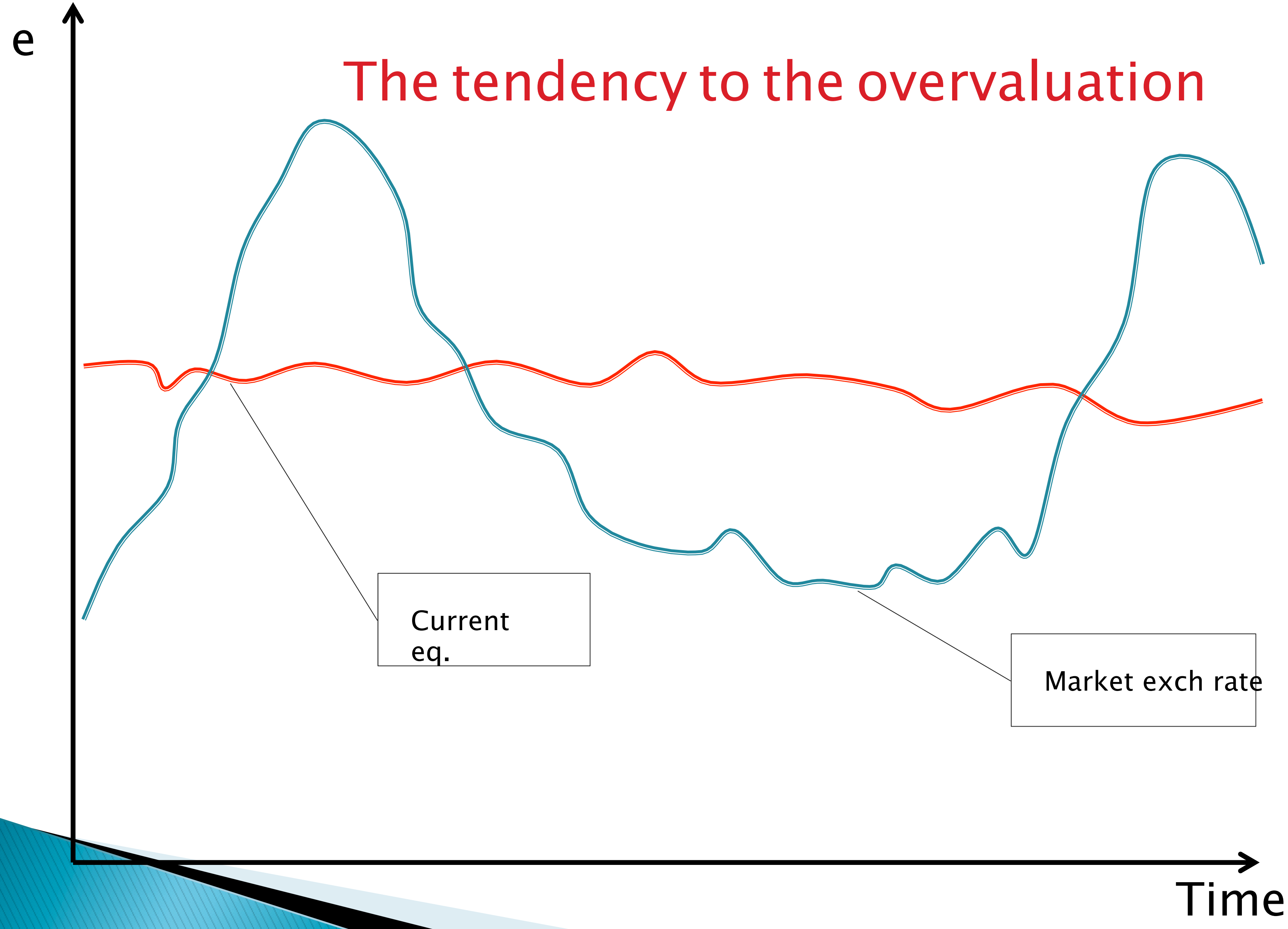
- Keynesian school – large misalignments

- New-developmentalism – tendency to the long-term overvaluation followed by cyclical currency crises, i.e., this "volatility" has a sense and is a long-term phenomenon.
- This is the core empirical thesis of new developmentalism.

Current equilibrium and neoclassical and Keynesian volatilities



The tendency to the overvaluation



5. Causes of the tendency to the overvaluation

- Structural cause the Dutch disease, but it just pulls the exchange rate to the current equilibrium
- Three habitual policies, which affect the demand and supply and explain the deficits.

1. Growth with foreign borrowing (“foreign savings”)
2. High level interest rate around which conduce monetary policy.
3. Exchange rate anchor policy to control inflation.

- If we add the text-book that impact on the supply and demand of foreign money (interest rate, effective demand, capital flows, capital controls, etc.), we have a complete theory of the determination of the exchange rate.

5.1. Dutch disease

- It is a long–term overvaluation of the exchange rate or a competitive disadvantage that stems from exports of commodities that, benefiting from Ricardian rents, can be exported with a profit at an exchange rate substantially more appreciated than the one required for the other tradeable firms that utilize technology in the world state of the art.
- Two equilibriums
- The commodities originating the Dutch disease define the current equilibrium, while the other competent tradable firms, the industrial equilibrium.

When there is Dutch disease

- The current equilibrium is mainly determined by the commodity prices (terms of trade), and secondarily by the CULCI of the commodities.

- The industrial equilibrium is mainly determined by the terms of trade of the non-commodity tradable goods and services.

Two exchange rate equilibriums

- Current equilibrium – value that balances intertemporally the current-account. Is expresses the value of the foreign money.

- Industrial or competitive equilibrium – value that makes competitive the firms that utilize technology in the world state of the art. (Belongs to the Dutch disease model).

Severity and neutralization of the Dutch disease

Severity

- It is equal to the distance between the current and the industrial equilibrium.
  - $g = (e_i - e_{c)} / e_c$

5.2-The three habitual policies

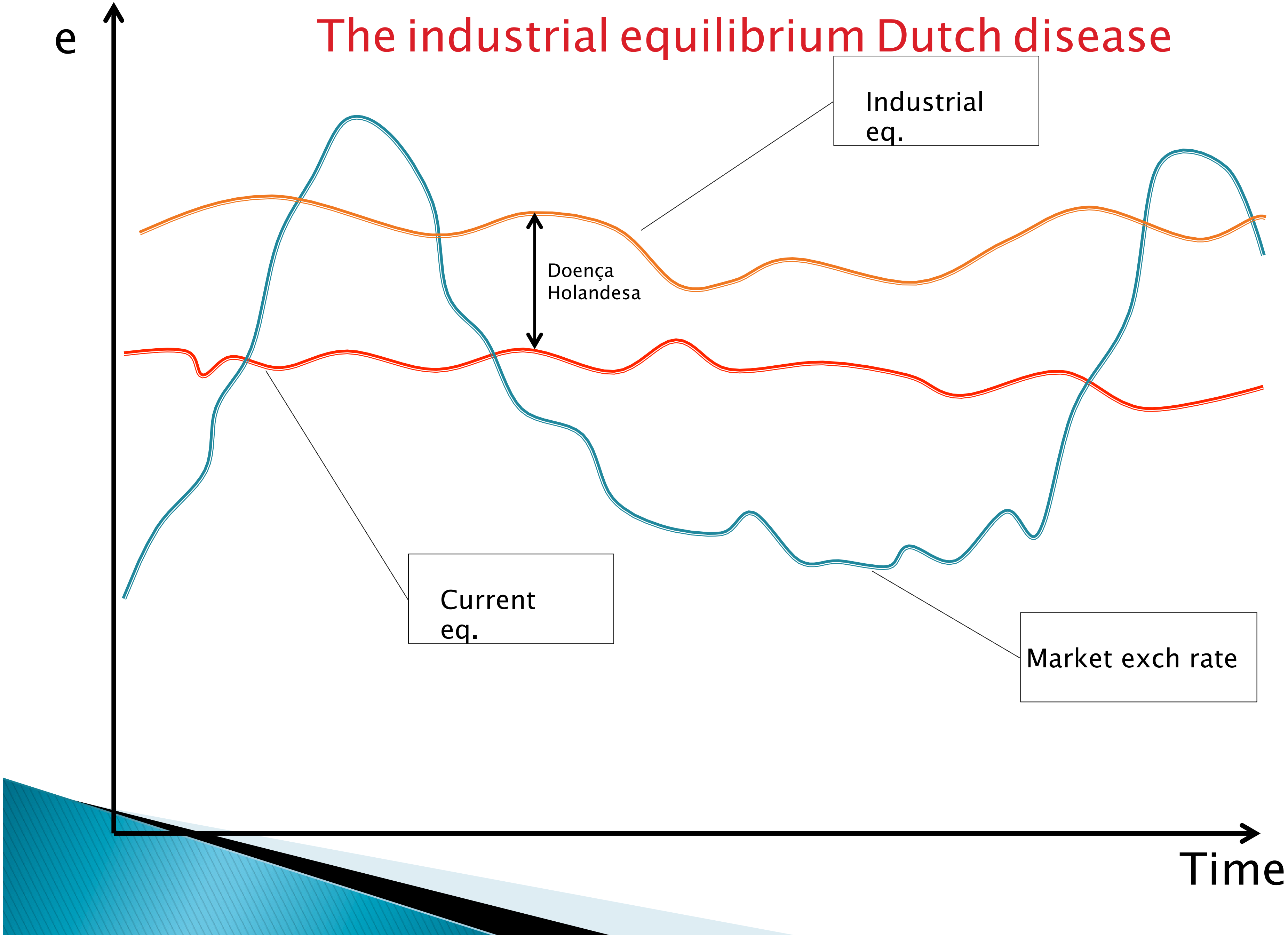
- Already referred when I discussed the demand and supply of foreign money as one of the determinants of the exchange rate.

Example of Brazil

		2006-14	Today
Current equilibrium	e_c	2.90	3.40
Industrial equilibrium	e_i	3.60	3.80
Severity of the DD	$(e_i - e_c) / e_c$	24%	12%
Real exchange rate (mket)	e	2.60	3.40
Overvaluation	$(e - e_i) / e_i$	-28%	-10%

Since 2010, the CULCI increases substantially, increasing the industrial equilibrium from R$ 3.60 to R$ 3.80.
In the second semester 2014, sharp fall in the price of commodities exported, increasing the current equilibrium from R$ 2.90 to R$ 3.40.
All equilibriums and exchange rates are in real terms.

The industrial equilibrium Dutch disease



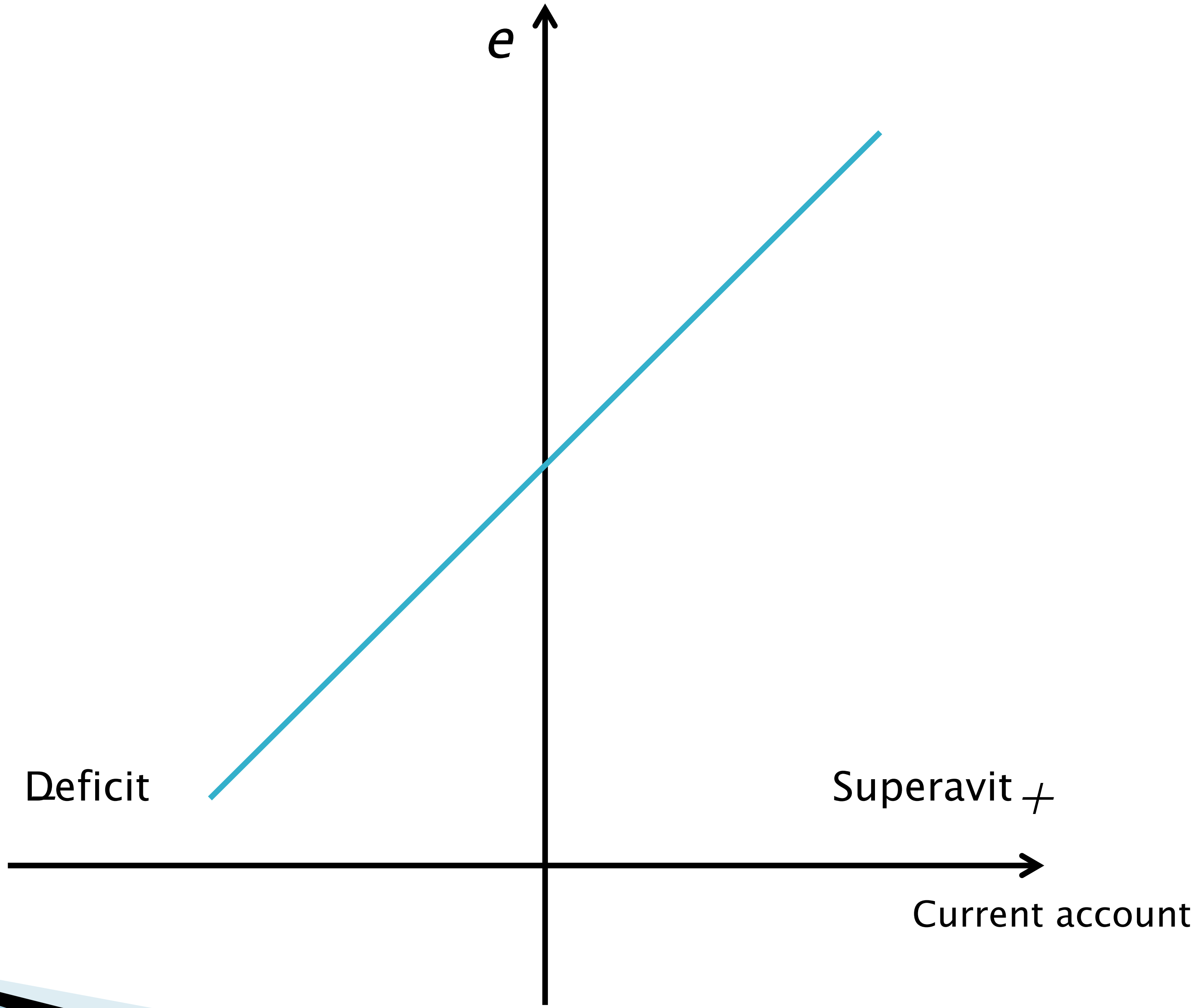
6.There is an inverted relation between the current account and the ER.

- The larger the CAD, the more valorized ER
- When the country decides "to grow with foreign savings", it incurs in CAD, the ER appreciates, and, either

1. investiments and savings are desencouraged,
2. and/or the appreciation increases revenues, and, giving high propensity to consume, consumption increases while domestic savings fall.

- In other words, there is a high rate of substitution of foreign for domestic savings.
- Thus, foreign savings don't add to domestic savings.

Current account and the exchange rate



The greater the current account deficit, the more overvalued the currency

7. Reccurrent currency crises

- They are, directly, the consequence of high current-account deficits and an overvalued currency.
- They could, additionally, be the indirect consequence of budget deficits. But:

1. Large budget deficits don't start up a fiscal crises (because countries that get indebted in their own money don't break down).
2. The twin deficits hypothesis does not hold when the exchange rate is overvalued,

8.Financialization is in the core of ND

- In a floating regime (that I am assuming)
- the dramatic increase in the foreign debt, which is required for a currency crises to break up, is only possible if a financial bubble tades place.
- Theycurrency crisis erupts when foreign creditors in foreign money loose confidence and stop rolling over the debt.
- Before that, only a financial bubble explains why foreign creditors kept financing the country notwithstanding the current account deficits were bigger than the “foreign debt equilibrium”.
- .

III- MACROECONOMIC POLICIES

- The state is supposed to provide the general conditions for capable business firms are competitive.
- This implies, on the supply side, to provide education, technical progress, investment in infrastructure, good institutions. These are well known long-term policies from which countries are aware and do their best;
- On the demand side, to keep the five macroeconomic prices, particularly the exchange rate are right. This is something that middle-income countries are not aware, and assures short-term gains.
- For this, the government is supposed to neutralize:

1. the tendency to the overvaluation,
2. the Dutch disease

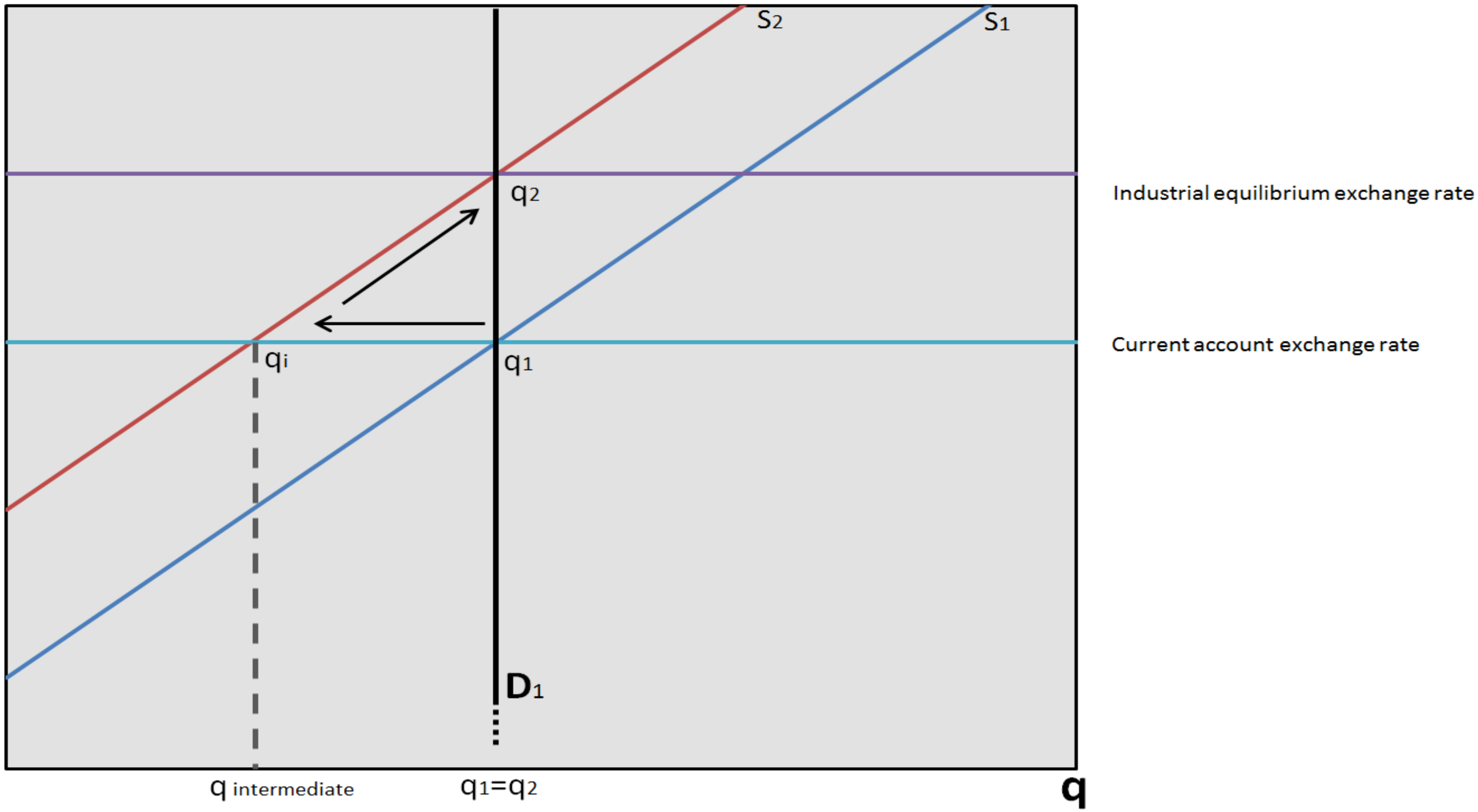
Neutralization of the Dutch disease

- A variable export-tax equal to the severity of the Dutch disease will neutralize it, making the current and the industrial equilibriums equal.
- Because:

1. Increase the value, i.e., the cost + profit.
2. Shifts the supply curve to the left.

- In the example, today the tax would be zero, between 2006-2014, would be in average, in today's prices, R$ 0.70 per US$.

Neutralization of the Dutch disease by shifting the supply curve



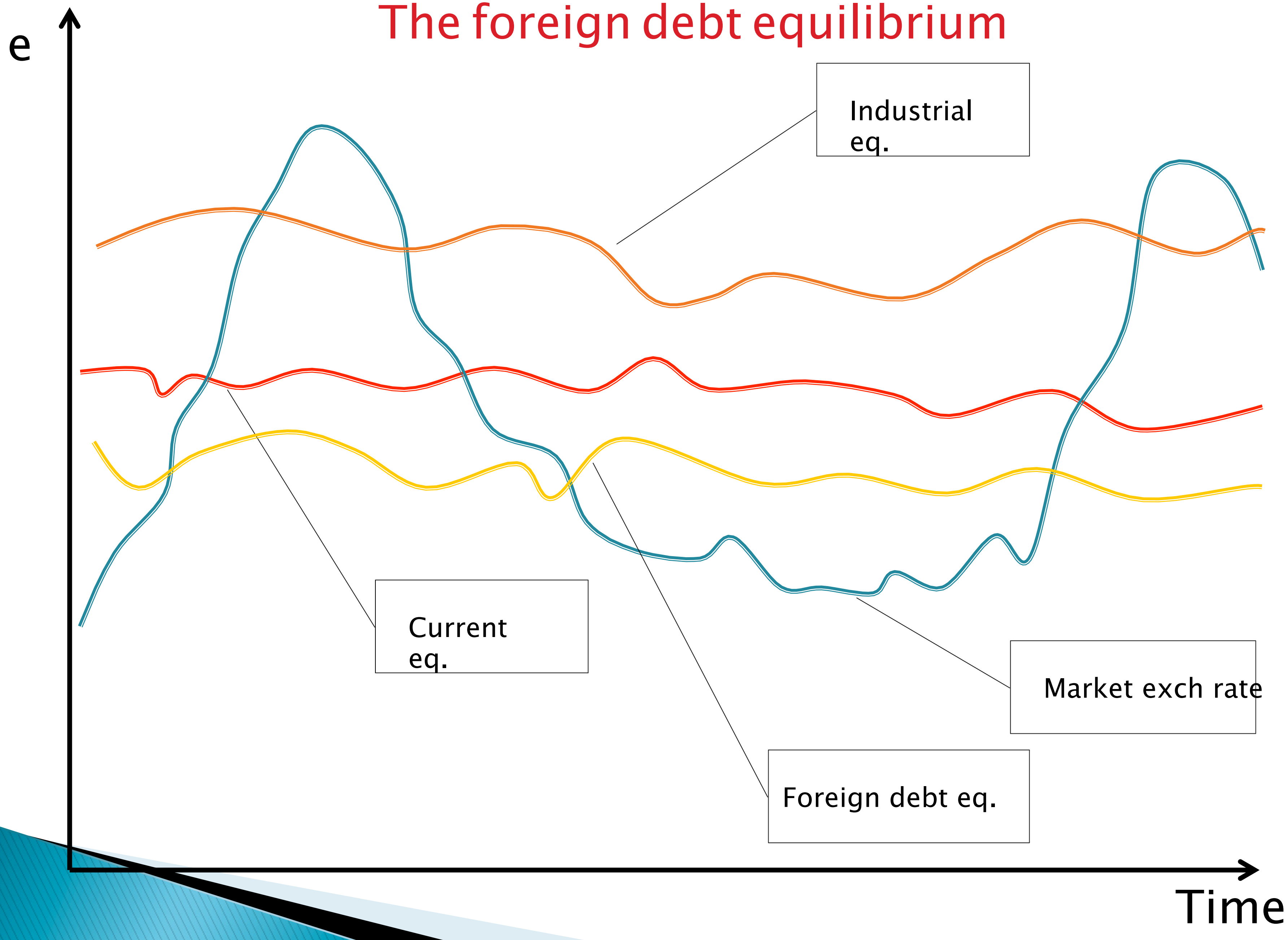
A third equilibrium: the foreign debt equilibrium

- Def: the foreign debt equilibrium is the exchange rate that corresponds to CAD in relation to GDP equal to the rate of growth of GDP.
- The foreign debt equilibrium corresponds loosely to what Williamson calls "fundamental exchange rate".
- The difference is that he (and economists in general) recommeds it, while I reject it.

The huge differences in recommending exchange rates

1. For new developmentalists: a competitive equilibrium consistent with current account surplus and a competitive exchange rate.
2. For the orthodoxy : the foreign debt equilibrium consistent with current account deficit and a non-competitive exchange rate.
3. For the exchange rate populists: below the foreign debt equilibrium, consistent with huge current account deficit, a highly non-competitive exchange rate, and explosive foreign debt.

The foreign debt equilibrium



Why to reject growth with foreign borrowing

- Because foreign savings don't add to domestic savings.

1. There is a high rate of substitution of foreign for domestic rates, except when the country is growing very fast and the marginal propensity to consume falls.
2. Cause: when the country decides "to grow with foreign savings", it incurs in current–account deficit, the exchange rate appreciate, investiments and desencouraged, and domestic savings fall.
3. Also a cause on the supply side: the appreciation increases revenues, increases consumption, domestic savings fall.

- Because, when the country neutralizes the Dutch disese, it will present a trade surplus (unless it, inconsistently, insists in growth with foreign savings)

Fiscal and monetary policy

- Keeping the public budget balanced, except when a clear countercyclical
- Keeping the level of the interest rate, around which the central banks realizes its monetary policy, low – just a little above rich countries.

Exchange rate policy to be set by an Exchange Rate Committee

To neutralize the tendency to the overvaluation of the exchange rate, by

- Neutralizing the Dutch disease;
- Rejecting the three habitual policies (which overvalue the exchange rate beyond the DD)

1. Growth with foreign borrowing (“savings”)
2. High level interest rate
3. Exchange rate anchor policy to control inflation

- controling capital flows, when needed.

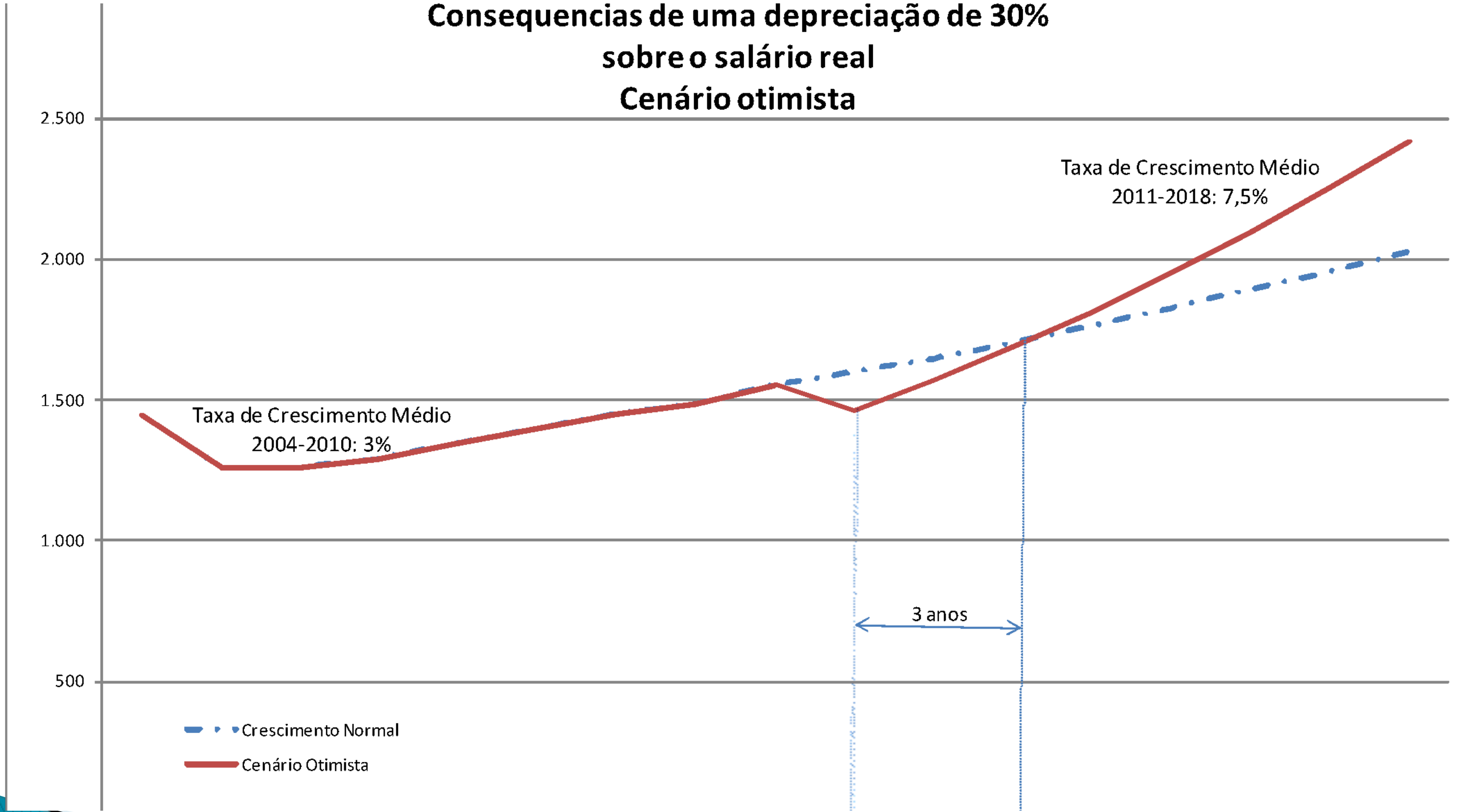
Export-led growth

- Theoretically, growth may only be wage-led when the country is in the import substitution short phase. (But concomitantly, countries faced huge increase in inequality)
- After it, the competitive advantage of developing countries indicates export-led.
- All countries with caught up were wage-led.
- Prebisch deduced from the foreign constraint industrialization; new developmentalism deduces from it exports of manufactured goods.

Policy consequences

- Short-term reduction of all revenues.
- Zero current-account, if the country doesn't have Dutch disease.
- A surplus current-account, if it has (the bigger the surplus, the more severe the Dutch disease.
- Financial stability
- Low inflation
- The rate of investment increases
- Faster growth
- Faster increase of wages.

Consequence of depreciation on wages



Which policies to reduce inequality?

- Not fiscal policy. It is not a distribution tool. Its objective is full employment and growth.
- Not appreciation of the exchange rate. Appreciation reduces profits (that will only valid if the profit rate is too high) and, yes, increases real wages, but also real interests, rents and dividends.
- It is a huge mistake to want high wages at the cost of an appreciated currency.

The real distributive policies:

- Minimum wage
- Expansion of the social state
- Financed by progressive taxation.
- Making low the long-term level of the interest rate.

Gini coefficient before and after taxes

(mid 2000s)

	Before taxes & transfers	After taxes & transfers	Variation %
Sweden	0.49	0.23	38.8
Germany	0.44	0.28	27.3
USA	0.46	0.34	26.1

Fim

Luiz Carlos Bresser-Pereira
Professor Emérito da Fundação Getúlio Vargas
www.bresserpereira.org.br