THE TENDENCY OF THE EXCHANGE RATE TO BECOME OVER-VALUED

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Economic development depends on a competitive exchange rate that stimulates exports and investments. Empirical evidence regarding this proposition is clear: all the countries that developed during the twentieth century, such as Japan, Germany, Italy and, more recently, the dynamic Asian countries, have always had exchange rates that enabled the development of their manufacturing industry. Recent econometric studies confirmed this fact.[1] On the other hand, economic theory teaches that developing countries should grow faster than rich ones, that is, they should be in a process of catching up, because those countries rely on a cheaper labor to compete internationally and because they can imitate and buy technology at a relatively low cost. This assumption of economic theory has been confirmed in practice by a number of Asian countries that have been growing at high rates for many years – which allowed, in 2005, developing countries as a whole to equal rich countries' GDP. It was also confirmed for some Latin American countries between 1930 and 1980. Yet, for most developing countries, even Latin American ones since 1980, growth rates per inhabitant are lower than those prevailing in rich countries.

The central reason for slow growth of middle income countries, for the fact that they fail in the catching up process, is that they fail to neutralize the tendency of the exchange rate to become over-valued. *This tendency has two main structural causes* – the Dutch disease and

[1] See, among others, Bresser-Pereira and Nakano (2002), Razin and Collins (1997), Fajnzylber, Loyaza and Calderón (2004), Gala (2006), Rodrik (2007).

the attraction that the higher rates of profit and of interest existing in developing countries exert over abundant international capitals. This attraction, on its hand, *is magnified by three policies*, two of them recommended by conventional orthodoxy (the growth with foreign savings policy and ‘capital deepening’), and the third is exchange rate populism.

This tendency derives mainly from the Dutch disease existing in practically all developing countries. This major market failure exists in different levels of gravity in the countries where abundant and cheap resources are origin of Ricardian rents. Such rents make the economic exploitation of the resource viable at a smaller exchange rate (more appreciated) than the one consistent with the international competitiveness of industries using technology in the state of the art. The consequence is that the only tradable good that the country is able to produce is the one(s) that originate the Dutch disease. A national development strategy will only materialize if the country is capable to neutralize the effects of the Dutch disease through the imposition of an export tax on the commodities that originate it.[2]

The other main causes of the tendency of the exchange rate to become over-valued are related to capital inflows. They are the outcome of the structural attraction that higher rates of profit and of interest cause on international capitals. But they are also the outcome of an insistent policy of growth with foreign savings that conventional orthodoxy recommends. Since business enterprises investments require finance, orthodox economists conclude that the country as a whole will also need foreign finance. Yet, this is a classical situation in which microeconomic reasoning (the need of finance on the part of entrepreneurs) cannot be transferred to the macroeconomic one. In some cases, foreign finance may be positive, but, as I show in Chapter 5, in most cases the attempt to grow with foreign savings fails: instead of increasing investments, they increase consumption. Countries that engage in the growth with foreign savings policy undergo three perverse stages. There is no need to criticize this strategy once it has come to the second or third stages, as the damage done to the country becomes obvious. I will therefore limit my analysis to stage one, at which the country has not yet

[2] The “Dutch disease” is consistent with the usual concept of equilibrium exchange rate: the one that intertemporally balances the current account. And it suggests an alternative growth concept of equilibrium exchange rate: the equilibrium exchange rate consistent with growth is the one that, given effective supply capacity, allows higher value added industries to be competitive internationally.

suspended international payments, or even gotten deep enough into debt to become dependent on creditors and therefore compelled to adopt the alienating practice of confidence building, but has fallen victim to the perverse process of substituting foreign savings for domestic ones because, through appreciation of the exchange rate, a sizable share of the foreign funds that should hypothetically increase investments end up as increased consumption.[3] As Barbosa Lima Sobrinho (1973), following Ragnar Nurkse (1953), puts in the title of one of his books, 'capital is made at home.' Only in special moments, when a country is growing at an extraordinary pace and expected profit rates are high, foreign savings or current account deficits may be positive in causing growth because in such moments the increase in real wages caused by exchange rate appreciation will not flow mostly to consumption but to investment.

The growth with foreign savings policy has as complementary policy the fiscal deepening policy. Financial deepening is just an elegant name to justify high interest rates that will attract capital inflows; it was introduced in the 1970s when many developing countries controlled and often kept negative interest rates by McKinnon (1973) and Shaw (1973). Besides, capital deepening should also convey earnestness in terms of economic policy, while administered interest rates, economic populism... Another complement to the growth cum foreign savings is the use of the exchange rate, and particularly of an exchange rate 'anchor' to control inflation. This policy became popular in the 1990s, after Argentina, in 1991, controlled hyperinflation by fixing the exchange rate in relation to the Dollar. The disastrous consequences of such policy are well known even by conventional orthodoxy that since late 1990s abandoned it in favor of a floating exchange rate. Yet, the practice of using exchange rate appreciation to control inflation remains a central to conventional orthodoxy. We saw in the last chapter that most of the success of Brazil in reducing inflation since 2002, when the depreciation of the Real pushed it around 10% is due to subsequent appreciation. On the other hand, when the exchange rate turns over-appreciated, the acceleration of inflation that depreciation will cause easily prevents it of taking place. This acceleration is temporary in an

[3] For a discussion of balance-of-payments crises or foreign exchange crises, see Alves, Ferrari Filho and Paula (2004). In their review, the authors distinguish first-, second- and third-generation models; these models invariably cast the public deficit in a leading role in explaining these crises. A PhD student of mine, Lauro

open, competitive and non-indexed economy; the inflation bubble will soon subside. But the stigma of high inflation can be significant, as it is in Brazil, so that, faced with any acceleration of inflation rates, however temporary, people fear the return of high inflation, legitimizing the Central Bank's interest rate hikes, even in the absence of excessive inflation, simply to appreciate the exchange rate and make sure that the exchange rate goes back down.

'Exchange rate populism' is also a cause of the tendency of the exchange rate to become over-valued. For some years, I have been using this expression to define the mal-practice of populist politicians that use the appreciation of the exchange rate to get reelected. An appreciated exchange rate is attractive in the short run as it implies higher real wages and higher profits, than a competitive rate will provide. The rich, who measure their wealth in dollars, see it grow every time the foreign exchange increases in value. The wages of the middle class, with its relatively high component of imported consumption, rises when the local currency gains value. Even the poorest benefit from real wage increases with non-competitive exchange rates, as a share of the products in their consumption basket becomes cheaper. The government's politicians have an interest in an appreciated exchange rate because it pleases voters and, as a result, they do not hesitate to practice what I have been calling foreign exchange populism. And the government's economists who accept conventional orthodoxy's single mandate for the Central Bank — controlling inflation — also have an interest in an appreciated exchange rate because they can say – as became usual in Brazil recently – that the appreciation of the Real was 'good' because it increased wages. In fact, we have two types of economic populism: fiscal populism, when the state expends more than it gets, and exchange rate populism when the nation-state expends more than it gets. Conventional orthodoxy criticizes the first, but is sympathetic to the second because exchange rate appreciation is consistent with its central proposal to developing countries (growth with foreign savings). Let us, then, examine first this policy, and then discuss the Dutch disease – the two main factors behind the tendency of the exchange rate to become over-valued. .

Gonzáles, is writing a thesis to show that the roles of the growth with foreign savings policy, and, therefore, current account deficits, are truly the deciding factor.

Demand and supply side

Dutch disease is an obstacle on the demand side with serious effects on supply. Since it implies exchange rate appreciation, the Dutch disease hinders investments even when the business enterprises fully dominate the respective technology. Conventional economics tends to consider economic growth merely in terms of supply, focusing its attention on education, on a broader improvement of human capital, on scientific and particularly on technological development, on innovation, and on investments in machines that increase the worker's productivity. Yet, as Keynes and Kalecki classically demonstrated, demand is not automatically created by supply, and therefore it may become an essential obstacle to economic growth. The huge unemployment of human resources, that exists in almost all developing countries presenting unsatisfactory growth rates, leaves no doubt that the main problem is often on the demand side, rather than on the supply side. Demand is formed by consumption, investments, public expenditure, and trade surplus, but the key variable are investments and exports, because they can be increased without incurring costs of reduced savings, as occurs with consumption, nor costs of fiscal imbalance, as occurs with public expenditure. Not only do they directly represent demand when there is a positive balance in commercial transactions, but, in addition, they encourage demand's main variable – investments – which operate as much on the supply side as on the demand side.[4] Exports are therefore strategic in order to solve the problem of insufficiency of demand or of unemployment.

When a country is still poor, that is, when it has not completed its Industrial Revolution, and does not have investment capacity or a class of entrepreneurs and middle-class professionals to conduct investments, the country will still be caught in the poverty trap, and the problem will probably be located mainly on the supply side. When, however, it has already gone through this stage, usually as a result of having profited from its natural resources in order to start a capitalist export activity, and became a medium-income country, the main obstacle to economic development will usually be located on the demand side: there will be a chronic

[4] Investment expenditure evidently also depends on other variables, besides increased exports, such as the interest rate and, particularly, business expectations regarding the future, but these latter shall be substantially better should the entrepreneurs rely on an exchange rate that stimulates them to export.

shortage of opportunities for lucrative investments in sectors producing tradable goods, whose main cause shall be the tendency of the exchange rate to become over-valued that exists in developing countries. This tendency, for its part, shall usually be caused mainly by the Dutch disease.

The exchange rate is, actually, the main variable to be studied by development macroeconomics, since it plays a strategic role in economic growth. If conditions exist on the supply side – and we should not overlook them – a relatively depreciated exchange rate is necessary in order to have a constant increase in exports and, as a consequence, an opportunity for lucrative investments. This is why countries that develop fast and manage to *catch up* usually have a competitive exchange rate, as it was the case with Japan, the other small Asian countries, and eventually China and India. When some of them (Thailand, Korea, and Malaysia), abandoned this policy in the 1990s and accepted conventional orthodoxy's recommendation of growing with foreign savings, thus appreciating their exchange rate, the outcome was the balance-of-payment crisis – a crisis that soon made them revert to the usual macroeconomic policy for those countries: strict fiscal adjustment, low interest rates, and competitive exchange rates (Gonzales 2007). The policy of managing the exchange rate and preventing its appreciation, thus neutralizing Dutch disease, is present in the dynamic Asian countries, not in Middle Eastern, African, and Latin American countries.[5] This difference could perhaps be explained by variables such as technical competence and rejection of economic populism, but it is equally due to the fact that Asian countries have relatively scarce natural resources, and therefore they are not subject to; even when they have abundant natural resources, such as Thailand, Malaysia, they did not base their growth on their exploitation.[6] We can always attribute the insufficient growth of medium-income countries to political or institutional issues, but in cases such as Brazil or Mexico, which between 1930 and 1980 have managed to *catch up*, this argument makes no sense: there are no new institutional historical facts to justify the assertion that these countries' institutional standards have worsened; they have rather become democracies with better institutions. There are, however, two new facts or

[5] Latin American countries used extensively exchange rate management up to the 1980s.

[6] They are only subject to the 'extended' Dutch disease, derived from the existence of cheap labor, whose concept I will discuss in the end of this chapter.

two main reasons that explain why medium-income countries such as those two, which grew considerably in the past, are not growing enough in the present: on the one hand, there was a substantial shrinking of public investments, and, on the other hand, since the end of 1980s those countries failed to neutralize the tendency of the exchange rate to become over-valued which is primarily caused by the Dutch disease.

This chapter has three basic arguments. First, the Dutch disease is the main determining factor of the tendency of the exchange rate to become overvalued, as well as a severe market failure resulting from the existence of Ricardian rents which may debilitate the country's economy indefinitely. Second, this disease can be neutralized through the management of the exchange rate and particularly through the creation of a tax on sales that will shift its supply curve upwards. Third, the Dutch disease does not derive only from natural resources but also from cheap labor, provided that the ‘wage spread’, that is, the difference between workers' wages and the salaries of engineers or managers in the factories is substantially higher in the country suffering the disease than in rich countries.

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