New Developmentalism: beyond competitive exchange rate

Novo Desenvolvimentismo: além da taxa de câmbio competitiva

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RESUMO: O objetivo deste artigo é mostrar que a obtenção de um nível competitivo para a taxa de câmbio real é uma condição necessária, embora não suficiente, para a recuperação dos países de renda média aos países desenvolvidos. Também é necessária uma mudança nas expectativas de longo prazo da taxa de câmbio real por parte dos empreendedores, o que exige a eliminação das causas subjacentes da tendência de supervalorização da taxa de câmbio real, que engloba a doença holandesa e a liberalização da conta de capital. Devido à existência de hiato tecnológico, a taxa de câmbio de equilíbrio industrial nos países de renda média pode ser maior o suficiente para compensar as empresas domésticas pelo atraso tecnológico em relação às empresas dos países desenvolvidos. Isso significa que há um espaço para as políticas industriais e de ciência e tecnologia no quadro teórico novo-desenvolvimentista.
PALAVRAS-CHAVE: Novo Desenvolvimentismo; equilíbrio industrial; doença holandesa; fluxos de capital.

ABSTRACT: The aim of this article is to show that the achievement of a competitive level for real exchange rate is a necessary, although not sufficient condition for the catching-up of middle-income countries to developed countries. It is also required a change in the long-term expectations of real exchange rate by entrepreneurs which requires the elimination of the underlying causes of the tendency of overvaluation of real exchange rate, that encompass the Dutch Disease and capital account liberalization. Due to the existence of technological gap, industrial equilibrium exchange rate in middle-income countries may be higher enough to compensate domestic firms for their technological backwardness relative to firms of developed countries. This means that there is a space for Industrial and Science and Technology Policies in the New-Developmentalist theoretical framework.
KEYWORDS: New Developmentalism; industrial equilibrium; Dutch Disease; capital flows.
JEL Classification: O11; O25; O40.

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One of the core propositions of the New-Developmental Brazilian school is that the tendency to overvaluation of the real exchange rate is one of the main obstacles to the catching-up process of middle-income countries (Bresser-Pereira, 2018, p. 57). This trend is the result of the operation of two distinct, although complementary, forces.The first one is the abundance of natural resources, the source of Dutch Disease. Since the publication of the Principles of Political Economy and Taxation by David Ricardo in 1817, we have known that the price of primary goods is determined by the production cost of the less efficient producer. Thus, countries with abundant natural resources are, by definition, countries in which the cost of production is lower than that prevailing in countries where natural resources are scarce. The difference between the cost of inframarginal production (in countries where natural resources are abundant) and the cost of marginal production (where natural resources are scarce) is what is called The Ricardian Income. As the cost of production encompasses the normal rate of return on capital applied in productive activity, it follows that activities related to the exploitation of natural resources end up obtaining an extra normal profit rate. Equalization of the profit rate among sectors therefore requires that the price of primary goods in the domestic currency to be reduced in order to approach the marginal cost of production. The only way this can occur is through an appreciation of the nominal exchange rate, which reduces the price in national currency of primary goods, given the price in foreign currency thereof in international markets.

The second source of appreciation of the exchange rate is foreign capital inflows. These inflows depend, however, on the liberalization of the capital account, something that may or may not be done by the governments of middle-income countries. In general, Latin American countries decided to open their capital accounts in the 1990s, while East Asian countries either kept their capital accounts relatively closed (such as China) or made a much more small opening than that was made by Latin American countries (as is the case in South Korea and other East Asian countries).

The opening of the capital account allows surplus capital in developed countries to seek higher returns on portfolio investments in middle-income countries. Returns on financial assets are higher in middle-income countries for two reasons: (i) the lowest liquidity due to lower organization of capital markets in middle-income countries, which is reflected in a higher risk premium for the assets of these countries relative to the assets of developed countries thus allowing greater profitability for investors ; (ii) the significant exchange rate appreciation resulting from the inflows of foreign capital in the relatively low liquid financial markets of middle-income countries acts to increase the asset return differential between middle income countries and developed countries, thus refueling the incentive for speculative capital inflows into the former.

The combination of Dutch Disease with the liberalization of the capital account in middle-income countries ends by generating a tendency to overvaluation of the exchange rate that is only reversed, for brief periods, by the occurrence of a currency crisis; that is, a sudden and strong devaluation of the exchange rate due to the sudden-stop of capital flows. However, after the most critical moment of the crisis had been hit, and the confidence of international markets has restored, capital inflows start again, making the exchange rate to appreciate, thus restarting the cycle of appreciation that will lead to the next currency crisis. This is the reason why this phenomenon is described in the new-developmental literature as a cyclical tendency to the overvaluation of the exchange rate (Bresser-Pereira, 2003).

This cyclical trend to overvalue the exchange rate is the cause of premature deindustrialization processes in middle-income countries and, therefore, their inability to catch-up (Oreiro, 2018).

The emphasis given to the role of the exchange rate in the catching-up process has attracted many academic criticisms, both from right and left of the economics profession. In this context, there is a remarkable convergence of opinion between liberal or orthodox economists and some heterodox economists: both reject the relevance of the exchange rate as a key variable for the catching-up process. On the liberal side, the criticism is that (i) the real exchange rate is an endogenous variable, resulting from social choices about consumption and savings, and is not, therefore, a variable that is under the control of economic policy; and (ii)catching-up is a process that depends essentially on the growth of Total Factor Productivity (TFP), which is, by hypothesis, independent of the sectoral composition of production, in particular the manufacturing share in GDP; thus, even if the real exchange rate could be managed by policy makers, it would have no relevance for the economic development process. On the heterodox side, the argument is that competitive exchange rates involve a reduction in the level of real wages, thus generating a redistribution of income from wages to profits and, therefore, a reduction in consumption demand. As investment depends on the level of use of productive capacity, the reduction in consumption will lead to a reduction in the level of capacity utilization and, therefore, a reduction in investment and the pace of capital accumulation. The end result would be a reduction in growth, thus making it impossible to catch-up.

These criticisms have already been adequately answered in Oreiro and Marconi (2016) and Oreiro (2018), so that I will not repeat the arguments here, inviting the reader interested to consult these articles. My goal in this article is another. I intend to show that, unlike the reigning common sense about the new-developmental school, obtaining a competitive exchange rate is not seen by new developmentalism thinking as a sufficient condition for the catching-up process.

Firstly, we need to have in mind that the possible achievement of a competitive level for the exchange rate does not mean that the cyclical trend to overvaluation of the exchange rate has been eliminated. The new-developmentalist theory is quite clear when stating that in times of currency crisis there is a strong and sudden devaluation of theexchange rate, which can give rise to exchange rate overshootingmovements, in which the exchange rate can become even undervalued (Bresser-Pereira, Oreiro and Marconi, 2015, p. 51). These movements do not, however, present the temporal persistence necessary to convince entrepreneurs that the exchange rate will remain, in a lasting way, on a competitive level; that is, they are not able to affect the long-term exchange rate expected by entrepreneurs, thus not being able to induce a sustained movement of structural change in the economy. For the exchange rate to operate as the "light switch" that gives entrepreneurs access to demand for their products; it is necessary that they expect the exchange rate to remain at a stable and competitive level in the medium and long term; which obviously requires the elimination of the underlying causes of the cyclical trend to overvaluation of the exchange rate, i.e., requires the neutralization of the Dutch Disease and the closure, albeit partial, of the capital account.

Secondly, the new-developmentalist literature defines the competitive level of the exchange rate as that level of the exchange rate for which domestic companies operating with technology in the state of the world art manage to compete with foreign companies both in the domestic and international market (Bresser-Pereira, Oreiro and Marconi, 2015, p. 59). The problem with this definition is that most companies in middle-income countries do not operate with technology in the state of the world art, but behind the technological frontier (Oreiro and Martins da Silva, 2019). Thus, the maintenance of the exchange rate at a level compatible with the so-called "industrial balance" is not sufficient to allow the development and expansion of companies in middle-income countries; it is thus necessary to implement industrial policies, science and technology and foreign trade that aim (i) gradually reduce the technological gap that separates domestic companies from their competitors in developed countries and (ii) ensure minimum conditions of survival and expansion for domestic companies while they do not reach the technological frontier. In this context, import tariffs can even be used for a limited and defined period of time, as a necessary instrument to ensure isonomic conditions for domestic companies in a context in which they have a significant technological lag with respect to their competitors abroad.

Thirdly, middle-income countries may face restrictions on the supply side of the economy, which may make the catching-up process impossible even if the exchange rate is operating permanently at the level of industrial equilibrium. Indeed, as shown in Bresser-Pereira, Oreiro and Marconi (2015, pp. 117-118); the growth rate of capital stock along the balanced growth path (in which the exchange rate is at the level of industrial equilibrium) may be insufficient for catching-up in a context where (i) the normal degree of capacity utilization is very low and/or (ii) capital productivity (i.e., the reciprocal capital-output ratio) is also very low. Under these conditions the obstacles to economic development will not be on the demand side, but on the supply side of the economy, which may require policies for the reduction of the degree of market concentration and the level of entry barriers, in order to increase the normal of capacity utilization; and for the increase in efficiency of the capital goods manufacturing sector, in order to reduce the supply price of capital equipment and increase the productivity of the capital equipment.

In short, it is not true that for the new-developmentalist school, everything is summarized to "put the exchange rate in the right level". In fact, the exchange rate is just one of five macroeconomic prices that need to be in "balance" so that the catching-up process can occur (Bresser-Pereira, 2018, pp. 139-145). In addition, new-developmentalist thinking also considers important the adoption of industrial, science and technology and foreign trade policies that are appropriate to eliminate the technological gap and thus allow domestic companies to be able to compete in the long-term on an effective level playing with companies in rich countries.

Finally, the new-developmental school states that the obstacles to the catch-up process by middle-income countries cannot be eliminated by market mechanisms. An active role of the State, alongside the private sector, is necessary for the success of any development strategy, as demonstrated exhaustively by the historical experience of developed countries (Chang, 2002).

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